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HOUSE OF REPRESENTATIVES

REPT. 108–548
Part 1

# AMERICAN JOBS CREATION ACT OF 2004

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## R E P O R T

OF THE

## COMMITTEE ON WAYS AND MEANS
## HOUSE OF REPRESENTATIVES

TO ACCOMPANY

## H.R. 4520

together with

## DISSENTING AND ADDITIONAL VIEWS

[Including cost estimate of the Congressional Budget Office]

June 16, 2004.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

108TH CONGRESS, 2d Session | HOUSE OF REPRESENTATIVES | REPT. 108–548 Part 1

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JUNE 16, 2004.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

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

## R E P O R T

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## DISSENTING AND ADDITIONAL VIEWS

[To accompany H.R. 4520]

[Including cost estimate of the Congressional Budget office]

The Committee on Ways and Means, to whom was referred the bill (H.R. 4520) to amend the Internal Revenue Code of 1986 to remove impediments in such Code and make our manufacturing, service, and high-technology businesses and workers more competitive and productive both at home and abroad, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

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The amendment is as follows:

Strike all after the enacting clause and insert the following:

**SECTION 1. SHORT TITLE; ETC.**

(a) SHORT TITLE.—This Act may be cited as the "American Jobs Creation Act of 2004".

(b) AMENDMENT OF 1986 CODE.—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1986.

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Subtitle C—S Corporation Reform and Simplification

Sec. 221. Members of family treated as 1 shareholder.
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Sec. 228. Treatment of bank director shares.
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Subtitle D—Alternative Minimum Tax Relief

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Subtitle G—Incentives to Reinvest Foreign Earnings in United States

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# TITLE I—END SANCTIONS AND REDUCE CORPORATE TAX RATES FOR DOMESTIC MANUFACTURING AND SMALL CORPORATIONS

**SEC. 101. REPEAL OF EXCLUSION FOR EXTRATERRITORIAL INCOME.**

(a) IN GENERAL.—Section 114 is hereby repealed.

(b) CONFORMING AMENDMENTS.—

(1) Subpart E of part III of subchapter N of chapter 1 (relating to qualifying foreign trade income) is hereby repealed.

(2) The table of subparts for such part III is amended by striking the item relating to subpart E.

(3) The table of sections for part III of subchapter B of chapter 1 is amended by striking the item relating to section 114.

(4) The second sentence of section 56(g)(4)(B)(i) is amended by striking "114 or".

(5) Section 275(a) is amended—

(A) by inserting "or" at the end of paragraph (4)(A), by striking "or" at the end of paragraph (4)(B) and inserting a period, and by striking subparagraph (C), and

(B) by striking the last sentence.

(6) Paragraph (3) of section 864(e) is amended—

(A) by striking:

"(3) TAX-EXEMPT ASSETS NOT TAKEN INTO ACCOUNT.—

"(A) IN GENERAL.—For purposes of"; and inserting:

"(3) TAX-EXEMPT ASSETS NOT TAKEN INTO ACCOUNT.—For purposes of", and

(B) by striking subparagraph (B).

(7) Section 903 is amended by striking "114, 164(a)," and inserting "164(a)".

(8) Section 999(c)(1) is amended by striking "941(a)(5),".

(c) EFFECTIVE DATE.—Except as provided in subsection (d), the amendments made by this section shall apply to transactions after December 31, 2004.

(d) TRANSITIONAL RULE FOR 2005 AND 2006.—

(1) IN GENERAL.—In the case of transactions during 2005 or 2006, the amount includible in gross income by reason of the amendments made by this section shall not exceed the applicable percentage of the amount which would have been so included but for this subsection.

(2) APPLICABLE PERCENTAGE.—For purposes of paragraph (1), the applicable percentage shall be as follows:

(A) For 2005, the applicable percentage shall be 20 percent.

(B) For 2006, the applicable percentage shall be 40 percent.

(e) REVOCATION OF ELECTION TO BE TREATED AS DOMESTIC CORPORATION.—If, during the 1-year period beginning on the date of the enactment of this Act, a corporation for which an election is in effect under section 943(e) of the Internal Revenue Code of 1986 revokes such election, no gain or loss shall be recognized with respect to property treated as transferred under clause (ii) of section 943(e)(4)(B) of such Code to the extent such property—

(1) was treated as transferred under clause (i) thereof, or

(2) was acquired during a taxable year to which such election applies and before May 1, 2003, in the ordinary course of its trade or business.

The Secretary of the Treasury (or such Secretary's delegate) may prescribe such regulations as may be necessary to prevent the abuse of the purposes of this subsection.

(f) BINDING CONTRACTS.—The amendments made by this section shall not apply to any transaction in the ordinary course of a trade or business which occurs pursuant to a binding contract—

(1) which is between the taxpayer and a person who is not a related person (as defined in section 943(b)(3) of such Code, as in effect on the day before the date of the enactment of this Act), and

(2) which is in effect on January 14, 2002, and at all times thereafter.

For purposes of this subsection, a binding contract shall include a purchase option, renewal option, or replacement option which is included in such contract and which is enforceable against the seller or lessor.

**SEC. 102. REDUCED CORPORATE INCOME TAX RATE FOR DOMESTIC PRODUCTION ACTIVITIES INCOME.**

(a) LIMITATION ON TAX ON QUALIFIED PRODUCTION ACTIVITIES INCOME.—Section 11 is amended by redesignating subsections (c) and (d) as subsections (d) and (e), respectively, and by inserting after subsection (b) the following new subsection:

"(c) LIMITATION ON TAX ON QUALIFIED PRODUCTION ACTIVITIES INCOME.—

"(1) IN GENERAL.—If a corporation has qualified production activities income for any taxable year, the tax imposed by this section shall not exceed the sum of—

"(A) a tax computed at the rates and in the manner as if this subsection had not been enacted on the taxable income reduced by the amount of qualified production activities income, plus

"(B) a tax equal to 32 percent (34 percent in the case of taxable years beginning before January 1, 2007) of the qualified production activities income (or, if less, taxable income).

"(2) QUALIFIED PRODUCTION ACTIVITIES INCOME.—

"(A) IN GENERAL.—The term 'qualified production activities income' for any taxable year means an amount equal to the excess (if any) of—

"(i) the taxpayer's domestic production gross receipts for such taxable year, over

"(ii) the sum of—

"(I) the cost of goods sold that are allocable to such receipts,

"(II) other deductions, expenses, or losses directly allocable to such receipts, and

"(III) a ratable portion of other deductions, expenses, and losses that are not directly allocable to such receipts or another class of income.

"(B) ALLOCATION METHOD.—The Secretary shall prescribe rules for the proper allocation of items of income, deduction, expense, and loss for purposes of determining income attributable to domestic production activities.

"(3) DOMESTIC PRODUCTION GROSS RECEIPTS.—For purposes of this subsection, the term 'domestic production gross receipts' means the gross receipts of the taxpayer which are derived from—

"(A) any lease, rental, license, sale, exchange, or other disposition of—

"(i) qualifying production property which was manufactured, produced, grown, or extracted in whole or in significant part by the taxpayer within the United States, or

"(ii) any qualified film produced by the taxpayer, or

"(B) construction, engineering, or architectural services performed in the United States for construction projects in the United States.

"(4) QUALIFYING PRODUCTION PROPERTY.—For purposes of this subsection, the term 'qualifying production property' means—

"(A) tangible personal property,

"(B) any computer software, and

"(C) any property described in section 168(f)(4).

"(5) QUALIFIED FILM.—For purposes of this subsection—

"(A) IN GENERAL.—The term 'qualified film' means any property described in section 168(f)(3) if not less than 50 percent of the total compensation relating to the production of such property is compensation for services performed in the United States by actors, production personnel, directors, and producers.

"(B) EXCEPTION.—Such term does not include property with respect to which records are required to be maintained under section 2257 of title 18, United States Code.

"(6) RELATED PERSONS.—For purposes of this subsection—

"(A) IN GENERAL.—The term 'domestic production gross receipts' shall not include any gross receipts of the taxpayer derived from property leased, licensed, or rented by the taxpayer for use by any related person.

"(B) RELATED PERSON.—For purposes of subparagraph (A), a person shall be treated as related to another person if such persons are treated as a single employer under subsection (a) or (b) of section 52 or subsection (m) or (o) of section 414, except that determinations under subsections (a) and (b) of section 52 shall be made without regard to section 1563(b).".

(b) SPECIAL RULE RELATING TO ELECTION TO TREAT CUTTING OF TIMBER AS A SALE OR EXCHANGE.—In the case of a corporation, any election under section 631(a) of the Internal Revenue Code of 1986 made for a taxable year ending on or before the date of the enactment of this Act may be revoked by the taxpayer for any taxable year ending after such date. For purposes of determining whether such tax-

payer may make a further election under such section, such election (and any revocation under this section) shall not be taken into account.

(c) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years beginning after December 31, 2004.

**SEC. 103. REDUCED CORPORATE INCOME TAX RATE FOR SMALL CORPORATIONS.**

(a) IN GENERAL.—Subsection (b) of section 11 (relating to tax imposed on corporations) is amended by redesignating paragraph (2) as paragraph (6) and by striking paragraph (1) and inserting the following new paragraphs:

"(1) FOR TAXABLE YEARS BEGINNING AFTER 2012.—In the case of taxable years beginning after 2012, the amount of the tax imposed by subsection (a) shall be determined in accordance with the following table:

| "If taxable income is: | The tax is: |
|---|---|
| Not over $50,000 | 15% of taxable income. |
| Over $50,000 but not over $75,000 | $7,500, plus 25% of the excess over $50,000. |
| Over $75,000 but not over $20,000,000 | $13,750, plus 32% of the excess over $75,000. |
| Over $20,000,000 | $6,389,750, plus 35% of the excess over $20,000,000. |

"(2) FOR TAXABLE YEARS BEGINNING IN 2011 OR 2012.—In the case of taxable years beginning in 2011 or 2012, the amount of the tax imposed by subsection (a) shall be determined in accordance with the following table:

| "If taxable income is: | The tax is: |
|---|---|
| Not over $50,000 | 15% of taxable income. |
| Over $50,000 but not over $75,000 | $7,500, plus 25% of the excess over $50,000. |
| Over $75,000 but not over $5,000,000 | $13,750, plus 32% of the excess over $75,000. |
| Over $5,000,000 but not over $10,000,000 | $1,589,750, plus 34% of the excess over $5,000,000. |
| Over $10,000,000 | $3,289,750, plus 35% of the excess over $10,000,000. |

"(3) FOR TAXABLE YEARS BEGINNING IN 2008, 2009, OR 2010.—In the case of taxable years beginning in 2008, 2009, or 2010, the amount of the tax imposed by subsection (a) shall be determined in accordance with the following table:

| "If taxable income is: | The tax is: |
|---|---|
| Not over $50,000 | 15% of taxable income. |
| Over $50,000 but not over $75,000 | $7,500, plus 25% of the excess over $50,000. |
| Over $75,000 but not over $1,000,000 | $13,750, plus 32% of the excess over $75,000. |
| Over $1,000,000 but not over $10,000,000 | $309,750, plus 34% of the excess over $1,000,000. |
| Over $10,000,000 | $3,369,750, plus 35% of the excess over $10,000,000. |

"(4) FOR TAXABLE YEARS BEGINNING IN 2005, 2006, OR 2007.—In the case of taxable years beginning in 2005, 2006, or 2007, the amount of the tax imposed by subsection (a) shall be determined in accordance with the following table:

| "If taxable income is: | The tax is: |
|---|---|
| Not over $50,000 | 15% of taxable income. |
| Over $50,000 but not over $75,000 | $7,500, plus 25% of the excess over $50,000. |
| Over $75,000 but not over $1,000,000 | $13,750, plus 33% of the excess over $75,000. |
| Over $1,000,000 but not over $10,000,000 | $319,000, plus 34% of the excess over $1,000,000. |
| Over $10,000,000 | $3,379,000, plus 35% of the excess over $10,000,000. |

"(5) PHASEOUT OF LOWER RATES FOR CERTAIN TAXPAYERS.—

"(A) GENERAL RULE FOR YEARS BEFORE 2013.—

"(i) IN GENERAL.—In the case of taxable years beginning before 2013 with respect to a corporation which has taxable income in excess of the applicable amount for any taxable year, the amount of tax determined under paragraph (1), (2), (3) or (4) for such taxable year shall be increased by the lesser of (I) 5 percent of such excess, or (II) the maximum increase amount.

"(ii) MAXIMUM INCREASE AMOUNT.—For purposes of clause (i)—

| "In the case of any taxable year beginning during: | The applicable amount is: | The maximum increase amount is: |
|---|---|---|
| 2005, 2006, or 2007 | $1,000,000 | $21,000 |
| 2008, 2009, or 2010 | $1,000,000 | $30,250 |
| 2011 or 2012 | $5,000,000 | $110,250. |

"(B) HIGHER INCOME CORPORATIONS.—In the case of a corporation which has taxable income in excess of $20,000,000 ($15,000,000 in the case of taxable years beginning before 2013), the amount of the tax determined under the foregoing provisions of this subsection shall be increased by an additional amount equal to the lesser of (i) 3 percent of such excess, or (ii) $610,250 ($100,000 in the case of taxable years beginning before 2013).".

(b) CONFORMING AMENDMENTS.—

(1) Section 904(b)(3)(D)(ii) is amended to read as follows:

"(ii) in the case of a corporation, section 1201(a) applies to such taxable year.".

(2) Section 1201(a) is amended by striking "the last 2 sentences of section 11(b)(1)" and inserting "section 11(b)(5)".

(3) Section 1561(a) is amended—

(A) by striking "the last 2 sentences of section 11(b)(1)" and inserting "section 11(b)(5)", and

(B) by striking "such last 2 sentences" and inserting "section 11(b)(5)".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2004.

# TITLE II—JOB CREATION TAX INCENTIVES FOR MANUFACTURERS, SMALL BUSINESSES, AND FARMERS

## Subtitle A—Small Business Expensing

**SEC. 201. 2-YEAR EXTENSION OF INCREASED EXPENSING FOR SMALL BUSINESS.**

Subsections (b), (c), and (d) of section 179 are each amended by striking "2006" each place it appears and inserting "2008".

## Subtitle B—Depreciation

**SEC. 211. RECOVERY PERIOD FOR DEPRECIATION OF CERTAIN LEASEHOLD IMPROVEMENTS AND RESTAURANT PROPERTY.**

(a) 15-YEAR RECOVERY PERIOD.—Subparagraph (E) of section 168(e)(3) (relating to classification of certain property) is amended by striking "and" at the end of clause (ii), by striking the period at the end of clause (iii) and inserting a comma, and by adding at the end the following new clauses:

"(iv) any qualified leasehold improvement property placed in service before January 1, 2006, and

"(v) any qualified restaurant property placed in service before January 1, 2006."

(b) QUALIFIED LEASEHOLD IMPROVEMENT PROPERTY.—Subsection (e) of section 168 is amended by adding at the end the following new paragraph:

"(6) QUALIFIED LEASEHOLD IMPROVEMENT PROPERTY.—The term 'qualified leasehold improvement property' has the meaning given such term in section 168(k)(3) except that the following special rules shall apply:

"(A) IMPROVEMENTS MADE BY LESSOR.—In the case of an improvement made by the person who was the lessor of such improvement when such improvement was placed in service, such improvement shall be qualified leasehold improvement property (if at all) only so long as such improvement is held by such person.

"(B) EXCEPTION FOR CHANGES IN FORM OF BUSINESS.—Property shall not cease to be qualified leasehold improvement property under subparagraph (A) by reason of—

"(i) death,

"(ii) a transaction to which section 381(a) applies,

"(iii) a mere change in the form of conducting the trade or business so long as the property is retained in such trade or business as qualified leasehold improvement property and the taxpayer retains a substantial interest in such trade or business,

"(iv) the acquisition of such property in an exchange described in section 1031, 1033, or 1038 to the extent that the basis of such property includes an amount representing the adjusted basis of other property owned by the taxpayer or a related person, or

"(v) the acquisition of such property by the taxpayer in a transaction described in section 332, 351, 361, 721, or 731 (or the acquisition of such property by the taxpayer from the transferee or acquiring corporation in a transaction described in such section), to the extent that the basis of the property in the hands of the taxpayer is determined by reference to its basis in the hands of the transferor or distributor.".

(c) QUALIFIED RESTAURANT PROPERTY.—Subsection (e) of section 168 (as amended by subsection (b)) is further amended by adding at the end the following new paragraph:

"(7) QUALIFIED RESTAURANT PROPERTY.—The term 'qualified restaurant property' means any section 1250 property which is an improvement to a building if—

"(A) such improvement is placed in service more than 3 years after the date such building was first placed in service, and

"(B) more than 50 percent of the building's square footage is devoted to preparation of, and seating for on-premises consumption of, prepared meals.".

(d) REQUIREMENT TO USE STRAIGHT LINE METHOD.—

(1) Paragraph (3) of section 168(b) is amended by adding at the end the following new subparagraphs:

"(G) Qualified leasehold improvement property described in subsection (e)(6).

"(H) Qualified restaurant property described in subsection (e)(7).".

(2) Subparagraph (A) of section 168(b)(2) is amended by inserting before the comma "not referred to in paragraph (3)".

(e) ALTERNATIVE SYSTEM.—The table contained in section 168(g)(3)(B) is amended by adding at the end the following new items:

| | |
|---|---|
| "(E)(iv) | 39 |
| "(E)(v) | 39". |

(f) EFFECTIVE DATE.—The amendments made by this section shall apply to property placed in service after the date of the enactment of this Act.

**SEC. 212. MODIFICATION OF DEPRECIATION ALLOWANCE FOR AIRCRAFT.**

(a) AIRCRAFT TREATED AS QUALIFIED PROPERTY.—

(1) IN GENERAL.—Paragraph (2) of section 168(k) is amended by redesignating subparagraphs (C) through (F) as subparagraphs (D) through (G), respectively, and by inserting after subparagraph (B) the following new subparagraph:

"(C) CERTAIN AIRCRAFT.—The term 'qualified property' includes property—

"(i) which meets the requirements of clauses (ii) and (iii) of subparagraph (A),

"(ii) which is an aircraft which is not a transportation property (as defined in subparagraph (B)(iii)) other than for agricultural or firefighting purposes,

"(iii) which is purchased and on which such purchaser, at the time of the contract for purchase, has made a nonrefundable deposit of the lesser of—

"(I) 10 percent of the cost, or

"(II) $100,000, and

"(iv) which has—

"(I) an estimated production period exceeding 4 months, and

"(II) a cost exceeding $200,000.".

(2) PLACED IN SERVICE DATE.—Clause (iv) of section 168(k)(2)(A) is amended by striking "subparagraph (B)" and inserting "subparagraphs (B) and (C)".

(b) CONFORMING AMENDMENTS.—

(1) Section 168(k)(2)(B) is amended by adding at the end the following new clause:

"(iv) APPLICATION OF SUBPARAGRAPH.—This subparagraph shall not apply to any property which is described in subparagraph (C).".

(2) Section 168(k)(4)(A)(ii) is amended by striking "paragraph (2)(C)" and inserting "paragraph (2)(D)".

(3) Section 168(k)(4)(B)(iii) is amended by inserting "and paragraph (2)(C)" after "of this paragraph)".

(4) Section 168(k)(4)(C) is amended by striking "subparagraphs (B) and (D)" and inserting "subparagraphs (B), (C), and (E)".

(5) Section 168(k)(4)(D) is amended by striking "Paragraph (2)(E)" and inserting "Paragraph (2)(F)".

(c) EFFECTIVE DATE.—The amendments made by this section shall take effect as if included in the amendments made by section 101 of the Job Creation and Worker Assistance Act of 2002.

**SEC. 213. MODIFICATION OF PLACED IN SERVICE RULE FOR BONUS DEPRECIATION PROPERTY.**

(a) IN GENERAL.—Section 168(k)(2)(D) (relating to special rules) is amended by adding at the end the following new clause:

"(iii) SYNDICATION.—For purposes of subparagraph (A)(ii), if—

"(I) property is originally placed in service after September 10, 2001, by the lessor of such property,

"(II) such property is sold by such lessor or any subsequent purchaser within 3 months after the date so placed in service (or, in the case of multiple units of property subject to the same lease, within 3 months after the date the final unit is placed in service, so long as the period between the time the first unit is placed in service and the time the last unit is placed in service does not exceed 12 months), and

"(III) the user of such property after the last sale during such 3-month period remains the same as when such property was originally placed in service,

such property shall be treated as originally placed in service not earlier than the date of such last sale, so long as no previous owner of such property elects the application of this subsection with respect to such property.".

(b) EFFECTIVE DATE.—The amendments made by this section shall take effect as if included in the amendments made by section 101 of the Job Creation and Worker Assistance Act of 2002; except that the parenthetical material in section 168(k)(2)(D)(iii)(II) of the Internal Revenue Code of 1986, as added by this section, shall apply to property sold after June 4, 2004.

# Subtitle C—S Corporation Reform and Simplification

**SEC. 221. MEMBERS OF FAMILY TREATED AS 1 SHAREHOLDER.**

(a) IN GENERAL.—Paragraph (1) of section 1361(c) (relating to special rules for applying subsection (b)) is amended to read as follows:

"(1) MEMBERS OF FAMILY TREATED AS 1 SHAREHOLDER.—

"(A) IN GENERAL.—For purpose of subsection (b)(1)(A)—

"(i) except as provided in clause (ii), a husband and wife (and their estates) shall be treated as 1 shareholder, and

"(ii) in the case of a family with respect to which an election is in effect under subparagraph (D), all members of the family shall be treated as 1 shareholder.

"(B) MEMBERS OF THE FAMILY.—For purpose of subparagraph (A)(ii)—

"(i) IN GENERAL.—The term 'members of the family' means the common ancestor, lineal descendants of the common ancestor, and the spouses (or former spouses) of such lineal descendants or common ancestor.

"(ii) COMMON ANCESTOR.—For purposes of this paragraph, an individual shall not be considered a common ancestor if, as of the later of the effective date of this paragraph or the time the election under section 1362(a) is made, the individual is more than 3 generations removed from the youngest generation of shareholders who would (but for this clause) be members of the family. For purposes of the preceding sentence, a spouse (or former spouse) shall be treated as being of the same generation as the individual to which such spouse is (or was) married.

"(C) EFFECT OF ADOPTION, ETC.—In determining whether any relationship specified in subparagraph (B) exists, the rules of section 152(b)(2) shall apply.

"(D) ELECTION.—An election under subparagraph (A)(ii)—

"(i) may, except as otherwise provided in regulations prescribed by the Secretary, be made by any member of the family, and

"(ii) shall remain in effect until terminated as provided in regulations prescribed by the Secretary.".

(b) RELIEF FROM INADVERTENT INVALID ELECTION OR TERMINATION.—Section 1362(f) (relating to inadvertent invalid elections or terminations), as amended by section 229, is amended—

(1) by inserting "or section 1361(c)(1)(A)(ii)" after "section 1361(b)(3)(B)(ii)," in paragraph (1), and

(2) by inserting "or section 1361(c)(1)(D)(iii)" after "section 1361(b)(3)(C)," in paragraph (1)(B).

(c) EFFECTIVE DATES.—

(1) SUBSECTION (a).—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 2004.

(2) SUBSECTION (b).—The amendments made by subsection (b) shall apply to elections and terminations made after December 31, 2004.

**SEC. 222. INCREASE IN NUMBER OF ELIGIBLE SHAREHOLDERS TO 100.**

(a) IN GENERAL.—Section 1361(b)(1)(A) (defining small business corporation) is amended by striking "75" and inserting "100".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years beginning after December 31, 2004.

**SEC. 223. EXPANSION OF BANK S CORPORATION ELIGIBLE SHAREHOLDERS TO INCLUDE IRAS.**

(a) IN GENERAL.—Section 1361(c)(2)(A) (relating to certain trusts permitted as shareholders) is amended by inserting after clause (v) the following new clause:

"(vi) In the case of a corporation which is a bank (as defined in section 581), a trust which constitutes an individual retirement account under section 408(a), including one designated as a Roth IRA under section 408A, but only to the extent of the stock held by such trust in such bank as of the date of the enactment of this clause.".

(b) TREATMENT AS SHAREHOLDER.—Section 1361(c)(2)(B) (relating to treatment as shareholders) is amended by adding at the end the following new clause:

"(vi) In the case of a trust described in clause (vi) of subparagraph (A), the individual for whose benefit the trust was created shall be treated as a shareholder.".

(c) SALE OF BANK STOCK IN IRA RELATING TO S CORPORATION ELECTION EXEMPT FROM PROHIBITED TRANSACTION RULES.—Section 4975(d) (relating to exemptions) is amended by striking "or" at the end of paragraph (14), by striking the period at the end of paragraph (15) and inserting "; or", and by adding at the end the following new paragraph:

"(16) a sale of stock held by a trust which constitutes an individual retirement account under section 408(a) to the individual for whose benefit such account is established if—

"(A) such stock is in a bank (as defined in section 581),

"(B) such stock is held by such trust as of the date of the enactment of this paragraph,

"(C) such sale is pursuant to an election under section 1362(a) by such bank,

"(D) such sale is for fair market value at the time of sale (as established by an independent appraiser) and the terms of the sale are otherwise at least as favorable to such trust as the terms that would apply on a sale to an unrelated party,

"(E) such trust does not pay any commissions, costs, or other expenses in connection with the sale, and

"(F) the stock is sold in a single transaction for cash not later than 120 days after the S corporation election is made.".

(d) CONFORMING AMENDMENT.—Section 512(e)(1) is amended by inserting "1361(c)(2)(A)(vi) or" before "1361(c)(6)".

(e) EFFECTIVE DATE.—The amendments made by this section shall take effect on the date of the enactment of this Act.

**SEC. 224. DISREGARD OF UNEXERCISED POWERS OF APPOINTMENT IN DETERMINING POTENTIAL CURRENT BENEFICIARIES OF ESBT.**

(a) IN GENERAL.—Section 1361(e)(2) (defining potential current beneficiary) is amended—

(1) by inserting "(determined without regard to any power of appointment to the extent such power remains unexercised at the end of such period)" after "of the trust" in the first sentence, and

(2) by striking "60-day" in the second sentence and inserting "1-year".

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2004.

**SEC. 225. TRANSFER OF SUSPENDED LOSSES INCIDENT TO DIVORCE, ETC.**

(a) IN GENERAL.—Section 1366(d)(2) (relating to indefinite carryover of disallowed losses and deductions) is amended to read as follows:

"(2) INDEFINITE CARRYOVER OF DISALLOWED LOSSES AND DEDUCTIONS.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), any loss or deduction which is disallowed for any taxable year by reason of paragraph (1) shall be treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder.

"(B) TRANSFERS OF STOCK BETWEEN SPOUSES OR INCIDENT TO DIVORCE.—In the case of any transfer described in section 1041(a) of stock of an S corporation, any loss or deduction described in subparagraph (A) with respect such stock shall be treated as incurred by the corporation in the succeeding taxable year with respect to the transferee."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years beginning after December 31, 2004.

**SEC. 226. USE OF PASSIVE ACTIVITY LOSS AND AT-RISK AMOUNTS BY QUALIFIED SUBCHAPTER S TRUST INCOME BENEFICIARIES.**

(a) IN GENERAL.—Section 1361(d)(1) (relating to special rule for qualified subchapter S trust) is amended—

(1) by striking "and" at the end of subparagraph (A),

(2) by striking the period at the end of subparagraph (B) and inserting ", and", and

(3) by adding at the end the following new subparagraph:

"(C) for purposes of applying sections 465 and 469 to the beneficiary of the trust, the disposition of the S corporation stock by the trust shall be treated as a disposition by such beneficiary.".

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to transfers made after December 31, 2004.

**SEC. 227. EXCLUSION OF INVESTMENT SECURITIES INCOME FROM PASSIVE INCOME TEST FOR BANK S CORPORATIONS.**

(a) IN GENERAL.—Section 1362(d)(3) (relating to where passive investment income exceeds 25 percent of gross receipts for 3 consecutive taxable years and corporation has accumulated earnings and profits) is amended by adding at the end the following new subparagraph:

"(F) EXCEPTION FOR BANKS; ETC.—In the case of a bank (as defined in section 581), a bank holding company (within the meaning of section 2(a) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(a))), or a financial holding company (within the meaning of section 2(p) of such Act), the term 'passive investment income' shall not include—

"(i) interest income earned by such bank or company, or

"(ii) dividends on assets required to be held by such bank or company, including stock in the Federal Reserve Bank, the Federal Home Loan Bank, or the Federal Agricultural Mortgage Bank or participation certificates issued by a Federal Intermediate Credit Bank.".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years beginning after December 31, 2004.

**SEC. 228. TREATMENT OF BANK DIRECTOR SHARES.**

(a) IN GENERAL.—Section 1361 (defining S corporation) is amended by adding at the end the following new subsection:

"(f) RESTRICTED BANK DIRECTOR STOCK.—

"(1) IN GENERAL.—Restricted bank director stock shall not be taken into account as outstanding stock of the S corporation in applying this subchapter (other than section 1368(f)).

"(2) RESTRICTED BANK DIRECTOR STOCK.—For purposes of this subsection, the term 'restricted bank director stock' means stock in a bank (as defined in section 581), a bank holding company (within the meaning of section 2(a) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(a))), or a financial holding company (within the meaning of section 2(p) of such Act), registered with the Federal Reserve System, if such stock—

"(A) is required to be held by an individual under applicable Federal or State law in order to permit such individual to serve as a director, and

"(B) is subject to an agreement with such bank or company (or a corporation which controls (within the meaning of section 368(c)) such bank or company) pursuant to which the holder is required to sell back such stock (at the same price as the individual acquired such stock) upon ceasing to hold the office of director.

"(3) CROSS REFERENCE.—

**"For treatment of certain distributions with respect to restricted bank director stock, see section 1368(f).".**

(b) DISTRIBUTIONS.—Section 1368 (relating to distributions) is amended by adding at the end the following new subsection:

"(f) RESTRICTED BANK DIRECTOR STOCK.—If a director receives a distribution (not in part or full payment in exchange for stock) from an S corporation with respect to any restricted bank director stock (as defined in section 1361(f)), the amount of such distribution—

"(1) shall be includible in gross income of the director, and

"(2) shall be deductible by the corporation for the taxable year of such corporation in which or with which ends the taxable year in which such amount in included in the gross income of the director.".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2004.

**SEC. 229. RELIEF FROM INADVERTENTLY INVALID QUALIFIED SUBCHAPTER S SUBSIDIARY ELECTIONS AND TERMINATIONS.**

(a) IN GENERAL.—Section 1362(f) (relating to inadvertent invalid elections or terminations) is amended—

(1) by inserting ", section 1361(b)(3)(B)(ii)," after "subsection (a)" in paragraph (1),

(2) by inserting ", section 1361(b)(3)(C)," after "subsection (d)" in paragraph (1)(B),

(3) by amending paragraph (3)(A) to read as follows:

"(A) so that the corporation for which the election was made is a small business corporation or a qualified subchapter S subsidiary, as the case may be, or",

(4) by amending paragraph (4) to read as follows:

"(4) the corporation for which the election was made, and each person who was a shareholder in such corporation at any time during the period specified pursuant to this subsection, agrees to make such adjustments (consistent with the treatment of such corporation as an S corporation or a qualified subchapter S subsidiary, as the case may be) as may be required by the Secretary with respect to such period,", and

(5) by inserting "or a qualified subchapter S subsidiary, as the case may be" after "S corporation" in the matter following paragraph (4).

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2004.

**SEC. 230. INFORMATION RETURNS FOR QUALIFIED SUBCHAPTER S SUBSIDIARIES.**

(a) IN GENERAL.—Section 1361(b)(3)(A) (relating to treatment of certain wholly owned subsidiaries) is amended by inserting "and in the case of information returns required under part III of subchapter A of chapter 61" after "Secretary".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years beginning after December 31, 2004.

**SEC. 231. REPAYMENT OF LOANS FOR QUALIFYING EMPLOYER SECURITIES.**

(a) IN GENERAL.—Subsection (f) of section 4975 (relating to other definitions and special rules) is amended by adding at the end the following new paragraph:

"(7) S CORPORATION REPAYMENT OF LOANS FOR QUALIFYING EMPLOYER SECURITIES.—A plan shall not be treated as violating the requirements of section 401 or 409 or subsection (e)(7), or as engaging in a prohibited transaction for purposes of subsection (d)(3), merely by reason of any distribution (as described in section 1368(a)) with respect to S corporation stock that constitutes qualifying employer securities, which in accordance with the plan provisions is used to make payments on a loan described in subsection (d)(3) the proceeds of which were used to acquire such qualifying employer securities (whether or not allocated to participants). The preceding sentence shall not apply in the case of a distribution which is paid with respect to any employer security which is allocated to a participant unless the plan provides that employer securities with a fair market value of not less than the amount of such distribution are allocated to such participant for the year which (but for the preceding sentence) such distribution would have been allocated to such participant.".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to distributions with respect to S corporation stock made after December 31, 2004.

# Subtitle D—Alternative Minimum Tax Relief

**SEC. 241. FOREIGN TAX CREDIT UNDER ALTERNATIVE MINIMUM TAX.**

(a) IN GENERAL.—

(1) Subsection (a) of section 59 is amended by striking paragraph (2) and by redesignating paragraphs (3) and (4) as paragraphs (2) and (3), respectively.

(2) Section 53(d)(1)(B)(i)(II) is amended by striking "and if section 59(a)(2) did not apply".

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2004.

**SEC. 242. EXPANSION OF EXEMPTION FROM ALTERNATIVE MINIMUM TAX FOR SMALL CORPORATIONS.**

(a) IN GENERAL.—Subparagraphs (A) and (B) of section 55(e)(1) are each amended by striking "$7,500,000" each place it appears and inserting "$20,000,000".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years beginning after December 31, 2005.

**SEC. 243. INCOME AVERAGING FOR FARMERS NOT TO INCREASE ALTERNATIVE MINIMUM TAX.**

(a) IN GENERAL.—Subsection (c) of section 55 (defining regular tax) is amended by redesignating paragraph (2) as paragraph (3) and by inserting after paragraph (1) the following new paragraph:

"(2) COORDINATION WITH INCOME AVERAGING FOR FARMERS.—Solely for purposes of this section, section 1301 (relating to averaging of farm income) shall not apply in computing the regular tax liability.".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 2003.

# Subtitle E—Restructuring of Incentives for Alcohol Fuels, Etc.

**SEC. 251. REDUCED RATES OF TAX ON GASOHOL REPLACED WITH EXCISE TAX CREDIT; REPEAL OF OTHER ALCOHOL-BASED FUEL INCENTIVES; ETC.**

(a) EXCISE TAX CREDIT FOR ALCOHOL FUEL MIXTURES.—

(1) IN GENERAL.—Subsection (f) of section 6427 is amended to read as follows:

"(f) ALCOHOL FUEL MIXTURES.—

"(1) IN GENERAL.—The amount of credit which would (but for section 40(c)) be determined under section 40(a)(1) for any period—

"(A) shall, with respect to taxable events occurring during such period, be treated—

"(i) as a payment of the taxpayer's liability for tax imposed by section 4081, and

"(ii) as received at the time of the taxable event, and

"(B) to the extent such amount of credit exceeds such liability for such period, shall (except as provided in subsection (k)) be paid subject to subsection (i)(3) by the Secretary without interest.

"(2) SPECIAL RULES.—

"(A) ONLY CERTAIN ALCOHOL TAKEN INTO ACCOUNT.—For purposes of paragraph (1), section 40 shall be applied—

"(i) by not taking into account alcohol with a proof of less than 190, and

"(ii) by treating as alcohol the alcohol gallon equivalent of ethyl tertiary butyl ether or other ethers produced from such alcohol.

"(B) TREATMENT OF REFINERS.—For purposes of paragraph (1), in the case of a mixture—

"(i) the alcohol in which is described in subparagraph (A)(ii), and

"(ii) which is produced by any person at a refinery prior to any taxable event,

section 40 shall be applied by treating such person as having sold such mixture at the time of its removal from the refinery (and only at such time) to another person for use as a fuel.

"(3) MIXTURES NOT USED AS FUEL.—Rules similar to the rules of subparagraphs (A) and (D) of section 40(d)(3) shall apply for purposes of this subsection.

"(4) TERMINATION.—This section shall apply only to periods to which section 40 applies, determined by substituting in section 40(e)—

"(A) 'December 31, 2010' for 'December 31, 2007', and

"(B) 'January 1, 2011' for 'January 1, 2008'."

(2) REVISION OF RULES FOR PAYMENT OF CREDIT.—Paragraph (3) of section 6427(i) is amended to read as follows:

"(3) SPECIAL RULE FOR ALCOHOL MIXTURE CREDIT.—

"(A) IN GENERAL.—A claim may be filed under subsection (f)(1)(B) by any person for any period—

"(i) for which $200 or more is payable under such subsection (f)(1)(B), and

"(ii) which is not less than 1 week.

In the case of an electronic claim, this subparagraph shall be applied without regard to clause (i).

"(B) PAYMENT OF CLAIM.—Notwithstanding subsection (f)(1)(B), if the Secretary has not paid pursuant to a claim filed under this section within 45 days of the date of the filing of such claim (20 days in the case of an electronic claim), the claim shall be paid with interest from such date determined by using the overpayment rate and method under section 6621.

"(C) TIME FOR FILING CLAIM.—No claim filed under this paragraph shall be allowed unless filed on or before the last day of the first quarter following the earliest quarter included in the claim."

(b) REPEAL OF OTHER INCENTIVES FOR FUEL MIXTURES.—

(1) Subsection (b) of section 4041 is amended to read as follows:

"(b) EXEMPTION FOR OFF-HIGHWAY BUSINESS USE.—

"(1) IN GENERAL.—No tax shall be imposed by subsection (a) or (d)(1) on liquids sold for use or used in an off-highway business use.

"(2) TAX WHERE OTHER USE.—If a liquid on which no tax was imposed by reason of paragraph (1) is used otherwise than in an off-highway business use, a tax shall be imposed by paragraph (1)(B), (2)(B), or (3)(A)(ii) of subsection (a) (whichever is appropriate) and by the corresponding provision of subsection (d)(1) (if any).

"(3) OFF-HIGHWAY BUSINESS USE DEFINED.—For purposes of this subsection, the term 'off-highway business use' has the meaning given to such term by section 6421(e)(2); except that such term shall not, for purposes of subsection (a)(1), include use in a diesel-powered train."

(2) Section 4041(k) is hereby repealed.

(3) Section 4081(c) is hereby repealed.

(4) Section 4091(c) is hereby repealed.

(c) TRANSFERS TO HIGHWAY TRUST FUND.—Paragraph (4) of section 9503(b) is amended by adding "or" at the end of subparagraph (B), by striking the comma at the end of subparagraph (C) and inserting a period, and by striking subparagraphs (D), (E), and (F).

(d) CONFORMING AMENDMENTS.—

(1) Subsection (c) of section 40 is amended to read as follows:

"(c) COORDINATION WITH EXCISE TAX BENEFITS.—The amount of the credit determined under this section with respect to any alcohol shall, under regulations prescribed by the Secretary, be properly reduced to take into account the benefit provided with respect to such alcohol under section 6427(f)."

(2) Subparagraph (B) of section 40(d)(4) is amended by striking "under section 4041(k) or 4081(c)" and inserting "under section 6427(f)".

(e) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as provided by paragraph (2), the amendments made by this section shall apply to fuel sold or used after September 30, 2004.

(2) SUBSECTION (c).—The amendments made by subsection (c) shall apply to taxes imposed after September 30, 2003.

**SEC. 252. ALCOHOL FUEL SUBSIDIES BORNE BY GENERAL FUND.**

(a) TRANSFERS TO FUND.—Section 9503(b)(1) is amended by adding at the end the following new flush sentence:

"For purposes of this paragraph, the amount of taxes received under section 4081 shall include any amount treated as a payment under section 6427(f)(1)(A) and shall not be reduced by the amount paid under section 6427(f)(1)(B).".

(b) TRANSFERS FROM FUND.—Subparagraph (A) of section 9503(c)(2) is amended by adding at the end the following new sentence: "Clauses (i)(III) and (ii) shall not apply to claims under section 6427(f)(1)(B)."

(c) EFFECTIVE DATE.—

(1) SUBSECTION (a).—The amendment made by subsection (a) shall apply to taxes received after September 30, 2004.

(2) SUBSECTION (b).—The amendment made by subsection (b) shall apply to amounts paid after September 30, 2004, and (to the extent related to section 34 of the Internal Revenue Code of 1986) to fuel used after such date.

# Subtitle F—Stock Options and Employee Stock Purchase Plan Stock Options

**SEC. 261. EXCLUSION OF INCENTIVE STOCK OPTIONS AND EMPLOYEE STOCK PURCHASE PLAN STOCK OPTIONS FROM WAGES.**

(a) EXCLUSION FROM EMPLOYMENT TAXES.—

(1) SOCIAL SECURITY TAXES.—

(A) Section 3121(a) (relating to definition of wages) is amended by striking "or" at the end of paragraph (20), by striking the period at the end of

paragraph (21) and inserting "; or", and by inserting after paragraph (21) the following new paragraph:

"(22) remuneration on account of—

"(A) a transfer of a share of stock to any individual pursuant to an exercise of an incentive stock option (as defined in section 422(b)) or under an employee stock purchase plan (as defined in section 423(b)), or

"(B) any disposition by the individual of such stock.".

(B) Section 209(a) of the Social Security Act is amended by striking "or" at the end of paragraph (17), by striking the period at the end of paragraph (18) and inserting "; or", and by inserting after paragraph (18) the following new paragraph:

"(19) Remuneration on account of—

"(A) a transfer of a share of stock to any individual pursuant to an exercise of an incentive stock option (as defined in section 422(b) of the Internal Revenue Code of 1986) or under an employee stock purchase plan (as defined in section 423(b) of such Code), or

"(B) any disposition by the individual of such stock.".

(2) RAILROAD RETIREMENT TAXES.—Subsection (e) of section 3231 is amended by adding at the end the following new paragraph:

"(12) QUALIFIED STOCK OPTIONS.—The term 'compensation' shall not include any remuneration on account of—

"(A) a transfer of a share of stock to any individual pursuant to an exercise of an incentive stock option (as defined in section 422(b)) or under an employee stock purchase plan (as defined in section 423(b)), or

"(B) any disposition by the individual of such stock.".

(3) UNEMPLOYMENT TAXES.—Section 3306(b) (relating to definition of wages) is amended by striking "or" at the end of paragraph (17), by striking the period at the end of paragraph (18) and inserting "; or", and by inserting after paragraph (18) the following new paragraph:

"(19) remuneration on account of—

"(A) a transfer of a share of stock to any individual pursuant to an exercise of an incentive stock option (as defined in section 422(b)) or under an employee stock purchase plan (as defined in section 423(b)), or

"(B) any disposition by the individual of such stock.".

(b) WAGE WITHHOLDING NOT REQUIRED ON DISQUALIFYING DISPOSITIONS.—Section 421(b) (relating to effect of disqualifying dispositions) is amended by adding at the end the following new sentence: "No amount shall be required to be deducted and withheld under chapter 24 with respect to any increase in income attributable to a disposition described in the preceding sentence.".

(c) WAGE WITHHOLDING NOT REQUIRED ON COMPENSATION WHERE OPTION PRICE IS BETWEEN 85 PERCENT AND 100 PERCENT OF VALUE OF STOCK.—Section 423(c) (relating to special rule where option price is between 85 percent and 100 percent of value of stock) is amended by adding at the end the following new sentence: "No amount shall be required to be deducted and withheld under chapter 24 with respect to any amount treated as compensation under this subsection.".

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to stock acquired pursuant to options exercised after the date of the enactment of this Act.

# Subtitle G—Incentives to Reinvest Foreign Earnings in United States

**SEC. 271. INCENTIVES TO REINVEST FOREIGN EARNINGS IN UNITED STATES.**

(a) IN GENERAL.—Subpart F of part III of subchapter N of chapter 1 (relating to controlled foreign corporations) is amended by adding at the end the following new section:

**"SEC. 965. TEMPORARY DIVIDENDS RECEIVED DEDUCTION.**

"(a) DEDUCTION.—

"(1) IN GENERAL.—In the case of a corporation which is a United States shareholder, there shall be allowed as a deduction an amount equal to 85 percent of the dividends which are received by such shareholder from controlled foreign corporations during the election period.

"(2) DIVIDENDS PAID INDIRECTLY FROM CONTROLLED FOREIGN CORPORATIONS.—If, within the election period, a United States shareholder receives a distribution from a controlled foreign corporation which is excluded from gross income under section 959(a), such distribution shall be treated for purposes of this section as a dividend to the extent of any amount included in income by such

United States shareholder under section 951(a)(1)(A) as a result of any dividend paid during the election period to—

"(A) such controlled foreign corporation from another controlled foreign corporation that is in a chain of ownership described in section 958(a), or

"(B) any other controlled foreign corporation in such chain of ownership, but only to the extent of distributions described in section 959(b) which are made during the election period to the controlled foreign corporation from which such United States shareholder received such distribution.

"(b) LIMITATIONS.—

"(1) IN GENERAL.—The amount of dividends taken into account under subsection (a) shall not exceed the greater of—

"(A) $500,000,000,

"(B) the amount shown on the applicable financial statement as earnings permanently reinvested outside the United States, or

"(C) in the case of an applicable financial statement which fails to show a specific amount of earnings permanently reinvested outside the United States and which shows a specific amount of tax liability attributable to such earnings, the amount of such earnings determined in such manner as the Secretary may prescribe.

Except as provided in subparagraph (C), if there is no statement or such statement fails to show a specific amount of such earnings or liability, such amount shall be treated as being zero for purposes of this paragraph.

"(2) DIVIDENDS MUST BE EXTRAORDINARY.—The amount of dividends taken into account under subsection (a) shall not exceed the excess (if any) of—

"(A) the dividends received during the taxable year by such shareholder from controlled foreign corporations, over

"(B) the annual average for the base period years of—

"(i) the dividends received during each base period year by such shareholder from such corporations,

"(ii) the amounts includible in such shareholder's gross income for each base period year under section 951(a)(1)(B) with respect to such corporations, and

"(iii) the amounts that would have been included for each base period year but for section 959(a) with respect to such corporations.

The amount taken into account under clause (iii) for any base period year shall not include any amount which is not includible in gross income by reason of an amount described in clause (ii) with respect to a prior taxable year.

"(3) REQUIREMENT TO INVEST IN UNITED STATES.—Subsection (a) shall not apply to any dividend received by a United States shareholder unless the amount of the dividend is invested in the United States pursuant to a plan describing the expenditures to be made with such amount—

"(A) which, before the dividend is received, is approved by the president or chief executive officer of such shareholder, and

"(B) which is approved by the Board of Directors (or management committee) of such shareholder no later than its first meeting on or after the date the dividend is received.

"(c) DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

"(1) ELECTION PERIOD.—The term 'election period' means—

"(A) if this section applies to the taxpayer's last taxable year beginning before the date of the enactment of this section, any 6-month or shorter period during such year which is after the date of the enactment of this section and which is selected by the taxpayer, and

"(B) if this section applies to the taxpayer's first taxable year beginning on or after such date, the 1st 6 months of such taxable year.

"(2) APPLICABLE FINANCIAL STATEMENT.—The term 'applicable financial statement' means the most recently audited financial statement (including notes and other documents which accompany such statement)—

"(A) which is certified on or before March 31, 2003, as being prepared in accordance with generally accepted accounting principles, and

"(B) which is used for the purposes of a statement or report—

"(i) to creditors,

"(ii) to shareholders, or

"(iii) for any other substantial nontax purpose.

In the case of a corporation required to file a financial statement with the Securities and Exchange Commission, such term means the most recent such statement filed on or before March 31, 2003.

"(3) BASE PERIOD YEARS.—The base period years are the 3 taxable years—

"(A) which are among the 5 most recent taxable years ending on or before March 31, 2003, and

"(B) which are determined by disregarding—

"(i) 1 taxable year for which the sum of the amounts described in clauses (i), (ii), and (iii) of subsection (b)(2)(B) is the largest, and

"(ii) 1 taxable year for which such sum is the smallest.

Rules similar to the rules of subparagraphs (A) and (B) of section 41(f)(3) shall apply for purposes of this paragraph.

"(4) COORDINATION WITH DIVIDENDS RECEIVED DEDUCTION.—No deduction shall be allowed under section 243 or 245 for any dividend for which a deduction is allowed under this section.

"(d) DENIAL OF FOREIGN TAX CREDIT.—

"(1) IN GENERAL.—No credit shall be allowed under section 901 for any taxes paid or accrued (or treated as paid or accrued) with respect to the deductible portion of any dividend or of any amount described in subsection (a)(2). No deduction shall be allowed under this chapter for any tax for which credit is not allowable by reason of the preceding sentence.

"(2) DEDUCTIBLE PORTION.—For purposes of paragraph (1), unless the taxpayer otherwise specifies, the deductible portion of any dividend is the amount which bears the same ratio to the amount of such dividend as the amount allowed as a deduction under subsection (a) for the taxable year bears to the amount described in subsection (b)(2)(A) for such year.

"(e) INCREASE IN TAX ON INCLUDED AMOUNTS NOT REDUCED BY CREDITS, ETC.—

"(1) IN GENERAL.—Any tax under this chapter by reason of nondeductible CFC dividends shall not be treated as tax imposed by this chapter for purposes of determining—

"(A) the amount of any credit allowable under this chapter, or

"(B) the amount of the tax imposed by section 55.

Subparagraph (A) shall not apply to the credit under section 53 or to the credit under section 27(a) with respect to taxes attributable to such dividends.

"(2) INCLUSIONS MAY NOT BE OFFSET BY NET OPERATING LOSSES.—

"(A) IN GENERAL.—The taxable income of any United States shareholder for any taxable year shall in no event be less than the amount of nondeductible CFC dividends received during such year.

"(B) COORDINATION WITH SECTION 172.—The nondeductible CFC dividends for any taxable year shall not be taken into account—

"(i) in determining under section 172 the amount of any net operating loss for such taxable year, and

"(ii) in determining taxable income for such taxable year for purposes of the 2nd sentence of section 172(b)(2).

"(3) NONDEDUCTIBLE CFC DIVIDENDS.—For purposes of this subsection, the term 'nondeductible CFC dividends' means the excess of the amount of dividends taken into account under subsection (a) over the deduction allowed under subsection (a) for such dividends.

"(f) ELECTION.—This section shall apply for the taxpayer's first taxable year beginning on or after the date of the enactment of this section if the taxpayer elects its application for such taxable year. The taxpayer may elect to apply this section to the taxpayer's last taxable year beginning before the date of the enactment of this section in lieu of such first taxable year."

(b) ALTERNATIVE MINIMUM TAX.—Subparagraph (C) of section 56(g)(4) is amended by adding at the end the following new clause:

"(v) SPECIAL RULE FOR CERTAIN DISTRIBUTIONS FROM CONTROLLED FOREIGN CORPORATIONS.—Clause (i) shall not apply to any deduction allowable under section 965.".

(c) CLERICAL AMENDMENT.—The table of sections for subpart F of part III of subchapter N of chapter 1 is amended by adding at the end the following new item:

"Sec. 965. Temporary dividends received deduction.".

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years ending on or after the date of the enactment of this Act.

# Subtitle H—Other Incentive Provisions

**SEC. 281. SPECIAL RULES FOR LIVESTOCK SOLD ON ACCOUNT OF WEATHER-RELATED CONDITIONS.**

(a) RULES FOR REPLACEMENT OF INVOLUNTARILY CONVERTED LIVESTOCK.—Subsection (e) of section 1033 (relating to involuntary conversions) is amended—

(1) by striking "CONDITIONS.—For purposes" and inserting "CONDITIONS.—

"(1) IN GENERAL.—For purposes", and

(2) by adding at the end the following new paragraph:

"(2) EXTENSION OF REPLACEMENT PERIOD.—

"(A) IN GENERAL.—In the case of drought, flood, or other weather-related conditions described in paragraph (1) which result in the area being designated as eligible for assistance by the Federal Government, subsection (a)(2)(B) shall be applied with respect to any converted property by substituting '4 years' for '2 years'.

"(B) FURTHER EXTENSION BY SECRETARY.—The Secretary may extend on a regional basis the period for replacement under this section (after the application of subparagraph (A)) for such additional time as the Secretary determines appropriate if the weather-related conditions which resulted in such application continue for more than 3 years.".

(b) INCOME INCLUSION RULES.—Subsection (e) of section 451 (relating to special rule for proceeds from livestock sold on account of drought, flood, or other weather-related conditions) is amended by adding at the end the following new paragraph:

"(3) SPECIAL ELECTION RULES.—If section 1033(e)(2) applies to a sale or exchange of livestock described in paragraph (1), the election under paragraph (1) shall be deemed valid if made during the replacement period described in such section.".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to any taxable year with respect to which the due date (without regard to extensions) for the return is after December 31, 2002.

**SEC. 282. PAYMENT OF DIVIDENDS ON STOCK OF COOPERATIVES WITHOUT REDUCING PATRONAGE DIVIDENDS.**

(a) IN GENERAL.—Subsection (a) of section 1388 (relating to patronage dividend defined) is amended by adding at the end the following: "For purposes of paragraph (3), net earnings shall not be reduced by amounts paid during the year as dividends on capital stock or other proprietary capital interests of the organization to the extent that the articles of incorporation or bylaws of such organization or other contract with patrons provide that such dividends are in addition to amounts otherwise payable to patrons which are derived from business done with or for patrons during the taxable year.".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to distributions in taxable years beginning after the date of the enactment of this Act.

**SEC. 283. CAPITAL GAIN TREATMENT UNDER SECTION 631(b) TO APPLY TO OUTRIGHT SALES BY LANDOWNERS.**

(a) IN GENERAL.—The first sentence of section 631(b) (relating to disposal of timber with a retained economic interest) is amended by striking "retains an economic interest in such timber" and inserting "either retains an economic interest in such timber or makes an outright sale of such timber".

(b) CONFORMING AMENDMENTS.—

(1) The third sentence of section 631(b) is amended by striking "The date of disposal" and inserting "In the case of disposal of timber with a retained economic interest, the date of disposal".

(2) The heading for section 631(b) is amended by striking "WITH A RETAINED ECONOMIC INTEREST".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to sales after December 31, 2004.

**SEC. 284. DISTRIBUTIONS FROM PUBLICLY TRADED PARTNERSHIPS TREATED AS QUALIFYING INCOME OF REGULATED INVESTMENT COMPANIES.**

(a) IN GENERAL.—Paragraph (2) of section 851(b) (defining regulated investment company) is amended to read as follows:

"(2) at least 90 percent of its gross income is derived from—

"(A) dividends, interest, payments with respect to securities loans (as defined in section 512(a)(5)), and gains from the sale or other disposition of stock or securities (as defined in section 2(a)(36) of the Investment Company Act of 1940, as amended) or foreign currencies, or other income (including but not limited to gains from options, futures or forward contracts) derived with respect to its business of investing in such stock, securities, or currencies, and

"(B) distributions or other income derived from an interest in a qualified publicly traded partnership (as defined in subsection (h)); and".

(b) SOURCE FLOW-THROUGH RULE NOT TO APPLY.—The last sentence of section 851(b) is amended by inserting "(other than a qualified publicly traded partnership as defined in subsection (h))" after "derived from a partnership".

(c) LIMITATION ON OWNERSHIP.—Subsection (c) of section 851 is amended by redesignating paragraph (5) as paragraph (6) and inserting after paragraph (4) the following new paragraph:

"(5) The term 'outstanding voting securities of such issuer' shall include the equity securities of a qualified publicly traded partnership (as defined in subsection (h)).".

(d) DEFINITION OF QUALIFIED PUBLICLY TRADED PARTNERSHIP.—Section 851 is amended by adding at the end the following new subsection:

"(h) QUALIFIED PUBLICLY TRADED PARTNERSHIP.—For purposes of this section, the term 'qualified publicly traded partnership' means a publicly traded partnership described in section 7704(b) other than a partnership which would satisfy the gross income requirements of section 7704(c)(2) if qualifying income included only income described in subsection (b)(2)(A).".

(e) DEFINITION OF QUALIFYING INCOME.—Section 7704(d)(4) is amended by striking "section 851(b)(2)" and inserting "section 851(b)(2)(A)".

(f) LIMITATION ON COMPOSITION OF ASSETS.—Subparagraph (B) of section 851(b)(3) is amended to read as follows:

"(B) not more than 25 percent of the value of its total assets is invested in—

"(i) the securities (other than Government securities or the securities of other regulated investment companies) of any one issuer,

"(ii) the securities (other than the securities of other regulated investment companies) of two or more issuers which the taxpayer controls and which are determined, under regulations prescribed by the Secretary, to be engaged in the same or similar trades or businesses or related trades or businesses, or

"(iii) the securities of one or more qualified publicly traded partnerships (as defined in subsection (h)).".

(g) APPLICATION OF SPECIAL PASSIVE ACTIVITY RULE TO REGULATED INVESTMENT COMPANIES.—Subsection (k) of section 469 (relating to separate application of section in case of publicly traded partnerships) is amended by adding at the end the following new paragraph:

"(4) APPLICATION TO REGULATED INVESTMENT COMPANIES.—For purposes of this section, a regulated investment company (as defined in section 851) holding an interest in a qualified publicly traded partnership (as defined in section 851(h)) shall be treated as a taxpayer described in subsection (a)(2) with respect to items attributable to such interest.".

(h) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

**SEC. 285. IMPROVEMENTS RELATED TO REAL ESTATE INVESTMENT TRUSTS.**

(a) EXPANSION OF STRAIGHT DEBT SAFE HARBOR.—Section 856 (defining real estate investment trust) is amended—

(1) in subsection (c) by striking paragraph (7), and

(2) by adding at the end the following new subsection:

"(m) SAFE HARBOR IN APPLYING SUBSECTION (c)(4).—

"(1) IN GENERAL.—In applying subclause (III) of subsection (c)(4)(B)(iii), except as otherwise determined by the Secretary in regulations, the following shall not be considered securities held by the trust:

"(A) Straight debt securities of an issuer which meet the requirements of paragraph (2).

"(B) Any loan to an individual or an estate.

"(C) Any section 467 rental agreement (as defined in section 467(d)), other than with a person described in subsection (d)(2)(B).

"(D) Any obligation to pay rents from real property (as defined in subsection (d)(1)).

"(E) Any security issued by a State or any political subdivision thereof, the District of Columbia, a foreign government or any political subdivision thereof, or the Commonwealth of Puerto Rico, but only if the determination of any payment received or accrued under such security does not depend in whole or in part on the profits of any entity not described in this subparagraph or payments on any obligation issued by such an entity,

"(F) Any security issued by a real estate investment trust.

"(G) Any other arrangement as determined by the Secretary.

"(2) SPECIAL RULES RELATING TO STRAIGHT DEBT SECURITIES.—

"(A) IN GENERAL.—For purposes of paragraph (1)(A), securities meet the requirements of this paragraph if such securities are straight debt, as defined in section 1361(c)(5) (without regard to subparagraph (B)(iii) thereof).

"(B) SPECIAL RULES RELATING TO CERTAIN CONTINGENCIES.—For purposes of subparagraph (A), any interest or principal shall not be treated as failing to satisfy section 1361(c)(5)(B)(i) solely by reason of the fact that—

"(i) the time of payment of such interest or principal is subject to a contingency, but only if—

"(I) any such contingency does not have the effect of changing the effective yield to maturity, as determined under section 1272, other than a change in the annual yield to maturity which does not exceed the greater of ¼ of 1 percent or 5 percent of the annual yield to maturity, or

"(II) neither the aggregate issue price nor the aggregate face amount of the issuer's debt instruments held by the trust exceeds $1,000,000 and not more than 12 months of unaccrued interest can be required to be prepaid thereunder, or

"(ii) the time or amount of payment is subject to a contingency upon a default or the exercise of a prepayment right by the issuer of the debt, but only if such contingency is consistent with customary commercial practice.

"(C) SPECIAL RULES RELATING TO CORPORATE OR PARTNERSHIP ISSUERS.—In the case of an issuer which is a corporation or a partnership, securities that otherwise would be described in paragraph (1)(A) shall be considered not to be so described if the trust holding such securities and any of its controlled taxable REIT subsidiaries (as defined in subsection (d)(8)(A)(iv)) hold any securities of the issuer which—

"(i) are not described in paragraph (1) (prior to the application of this subparagraph), and

"(ii) have an aggregate value greater than 1 percent of the issuer's outstanding securities determined without regard to paragraph (3)(A)(i).

"(3) LOOK-THROUGH RULE FOR PARTNERSHIP SECURITIES.—

"(A) IN GENERAL.—For purposes of applying subclause (III) of subsection (c)(4)(B)(iii)—

"(i) a trust's interest as a partner in a partnership (as defined in section 7701(a)(2)) shall not be considered a security, and

"(ii) the trust shall be deemed to own its proportionate share of each of the assets of the partnership.

"(B) DETERMINATION OF TRUST'S INTEREST IN PARTNERSHIP ASSETS.—For purposes of subparagraph (A), with respect to any taxable year beginning after the date of the enactment of this subparagraph—

"(i) the trust's interest in the partnership assets shall be the trust's proportionate interest in any securities issued by the partnership (determined without regard to subparagraph (A)(i) and paragraph (4), but not including securities described in paragraph (1)), and

"(ii) the value of any debt instrument shall be the adjusted issue price thereof, as defined in section 1272(a)(4).

"(4) CERTAIN PARTNERSHIP DEBT INSTRUMENTS NOT TREATED AS A SECURITY.—For purposes of applying subclause (III) of subsection (c)(4)(B)(iii)—

"(A) any debt instrument issued by a partnership and not described in paragraph (1) shall not be considered a security to the extent of the trust's interest as a partner in the partnership, and

"(B) any debt instrument issued by a partnership and not described in paragraph (1) shall not be considered a security if at least 75 percent of the partnership's gross income (excluding gross income from prohibited transactions) is derived from sources referred to in subsection (c)(3).

"(5) SECRETARIAL GUIDANCE.—The Secretary is authorized to provide guidance (including through the issuance of a written determination, as defined in section 6110(b)) that an arrangement shall not be considered a security held by the trust for purposes of applying subclause (III) of subsection (c)(4)(B)(iii) notwithstanding that such arrangement otherwise could be considered a security under subparagraph (F) of subsection (c)(5).".

(b) CLARIFICATION OF APPLICATION OF LIMITED RENTAL EXCEPTION.—Subparagraph (A) of section 856(d)(8) (relating to special rules for taxable REIT subsidiaries) is amended to read as follows:

"(A) LIMITED RENTAL EXCEPTION.—

"(i) IN GENERAL.—The requirements of this subparagraph are met with respect to any property if at least 90 percent of the leased space of the property is rented to persons other than taxable REIT subsidiaries of such trust and other than persons described in paragraph (2)(B).

"(ii) RENTS MUST BE SUBSTANTIALLY COMPARABLE.—Clause (i) shall apply only to the extent that the amounts paid to the trust as rents from real property (as defined in paragraph (1) without regard to paragraph (2)(B)) from such property are substantially comparable to such rents paid by the other tenants of the trust's property for comparable space.

"(iii) TIMES FOR TESTING RENT COMPARABILITY.—The substantial comparability requirement of clause (ii) shall be treated as met with respect to a lease to a taxable REIT subsidiary of the trust if such requirement is met under the terms of the lease—

"(I) at the time such lease is entered into,

"(II) at the time of each extension of the lease, including a failure to exercise a right to terminate, and

"(III) at the time of any modification of the lease between the trust and the taxable REIT subsidiary if the rent under such lease is effectively increased pursuant to such modification.

With respect to subclause (III), if the taxable REIT subsidiary of the trust is a controlled taxable REIT subsidiary of the trust, the term 'rents from real property' shall not in any event include rent under such lease to the extent of the increase in such rent on account of such modification.

"(iv) CONTROLLED TAXABLE REIT SUBSIDIARY.—For purposes of clause (iii), the term 'controlled taxable REIT subsidiary' means, with respect to any real estate investment trust, any taxable REIT subsidiary of such trust if such trust owns directly or indirectly—

"(I) stock possessing more than 50 percent of the total voting power of the outstanding stock of such subsidiary, or

"(II) stock having a value of more than 50 percent of the total value of the outstanding stock of such subsidiary.

"(v) CONTINUING QUALIFICATION BASED ON THIRD PARTY ACTIONS.—If the requirements of clause (i) are met at a time referred to in clause (iii), such requirements shall continue to be treated as met so long as there is no increase in the space leased to any taxable REIT subsidiary of such trust or to any person described in paragraph (2)(B).

"(vi) CORRECTION PERIOD.—If there is an increase referred to in clause (v) during any calendar quarter with respect to any property, the requirements of clause (iii) shall be treated as met during the quarter and the succeeding quarter if such requirements are met at the close of such succeeding quarter.".

(c) DELETION OF CUSTOMARY SERVICES EXCEPTION.—Subparagraph (B) of section 857(b)(7) (relating to redetermined rents) is amended by striking clause (ii) and by redesignating clauses (iii), (iv), (v), (vi), and (vii) as clauses (ii), (iii), (iv), (v), and (vi), respectively.

(d) CONFORMITY WITH GENERAL HEDGING DEFINITION.—Subparagraph (G) of section 856(c)(5) (relating to treatment of certain hedging instruments) is amended to read as follows:

"(G) TREATMENT OF CERTAIN HEDGING INSTRUMENTS.—Except to the extent provided by regulations, any income of a real estate investment trust from a hedging transaction (as defined in clause (ii) or (iii) of section 1221(b)(2)(A)) which is clearly identified pursuant to section 1221(a)(7), including gain from the sale or disposition of such a transaction, shall not constitute gross income under paragraph (2) to the extent that the transaction hedges any indebtedness incurred or to be incurred by the trust to acquire or carry real estate assets.".

(e) CONFORMITY WITH REGULATED INVESTMENT COMPANY RULES.—Clause (i) of section 857(b)(5)(A) (relating to imposition of tax in case of failure to meet certain requirements) is amended by striking "90 percent" and inserting "95 percent".

(f) SAVINGS PROVISIONS.—

(1) RULES OF APPLICATION FOR FAILURE TO SATISFY SECTION 856(c)(4).—Section 856(c) (relating to definition of real estate investment trust) is amended by inserting after paragraph (6) the following new paragraph:

"(7) RULES OF APPLICATION FOR FAILURE TO SATISFY PARAGRAPH (4).—

"(A) DE MINIMIS FAILURE.—A corporation, trust, or association that fails to meet the requirements of paragraph (4)(B)(iii) for a particular quarter shall nevertheless be considered to have satisfied the requirements of such paragraph for such quarter if—

"(i) such failure is due to the ownership of assets the total value of which does not exceed the lesser of—

"(I) 1 percent of the total value of the trust's assets at the end of the quarter for which such measurement is done, and

"(II) $10,000,000, and

"(ii)(I) the corporation, trust, or association, following the identification of such failure, disposes of assets in order to meet the requirements of such paragraph within 6 months after the last day of the quarter in which the corporation, trust or association's identification of the failure to satisfy the requirements of such paragraph occurred or such other time period prescribed by the Secretary and in the manner prescribed by the Secretary, or

"(II) the requirements of such paragraph are otherwise met within the time period specified in subclause (I).

"(B) FAILURES EXCEEDING DE MINIMIS AMOUNT.—A corporation, trust, or association that fails to meet the requirements of paragraph (4) for a particular quarter shall nevertheless be considered to have satisfied the requirements of such paragraph for such quarter if—

"(i) such failure involves the ownership of assets the total value of which exceeds the de minimis standard described in subparagraph (A)(i) at the end of the quarter for which such measurement is done,

"(ii) following the corporation, trust, or association's identification of the failure to satisfy the requirements of such paragraph for a particular quarter, a description of each asset that causes the corporation, trust, or association to fail to satisfy the requirements of such paragraph at the close of such quarter of any taxable year is set forth in a schedule for such quarter filed in accordance with regulations prescribed by the Secretary,

"(iii) the failure to meet the requirements of such paragraph for a particular quarter is due to reasonable cause and not due to willful neglect,

"(iv) the corporation, trust, or association pays a tax computed under subparagraph (C), and

"(v)(I) the corporation, trust, or association disposes of the assets set forth on the schedule specified in clause (ii) within 6 months after the last day of the quarter in which the corporation, trust or association's identification of the failure to satisfy the requirements of such paragraph occurred or such other time period prescribed by the Secretary and in the manner prescribed by the Secretary, or

"(II) the requirements of such paragraph are otherwise met within the time period specified in subclause (I).

"(C) TAX.—For purposes of subparagraph (B)(iv)—

"(i) TAX IMPOSED.—If a corporation, trust, or association elects the application of this subparagraph, there is hereby imposed a tax on the failure described in subparagraph (B) of such corporation, trust, or association. Such tax shall be paid by the corporation, trust, or association.

"(ii) TAX COMPUTED.—The amount of the tax imposed by clause (i) shall be the greater of—

"(I) $50,000, or

"(II) the amount determined (pursuant to regulations promulgated by the Secretary) by multiplying the net income generated by the assets described in the schedule specified in subparagraph (B)(ii) for the period specified in clause (iii) by the highest rate of tax specified in section 11.

"(iii) PERIOD.—For purposes of clause (ii)(II), the period described in this clause is the period beginning on the first date that the failure to satisfy the requirements of such paragraph (4) occurs as a result of the ownership of such assets and ending on the earlier of the date on which the trust disposes of such assets or the end of the first quarter when there is no longer a failure to satisfy such paragraph (4).

"(iv) ADMINISTRATIVE PROVISIONS.—For purposes of subtitle F, the taxes imposed by this subparagraph shall be treated as excise taxes with respect to which the deficiency procedures of such subtitle apply.".

(2) MODIFICATION OF RULES OF APPLICATION FOR FAILURE TO SATISFY SECTIONS 856(c)(2) OR 856(c)(3).—Paragraph (6) of section 856(c) (relating to definition of real estate investment trust) is amended by striking subparagraphs (A) and (B), by redesignating subparagraph (C) as subparagraph (B), and by inserting before subparagraph (B) (as so redesignated) the following new subparagraph:

"(A) following the corporation, trust, or association's identification of the failure to meet the requirements of paragraph (2) or (3), or of both such

paragraphs, for any taxable year, a description of each item of its gross income described in such paragraphs is set forth in a schedule for such taxable year filed in accordance with regulations prescribed by the Secretary, and".

(3) REASONABLE CAUSE EXCEPTION TO LOSS OF REIT STATUS IF FAILURE TO SATISFY REQUIREMENTS.—Subsection (g) of section 856 (relating to termination of election) is amended—

(A) in paragraph (1) by inserting before the period at the end of the first sentence the following: "unless paragraph (5) applies", and

(B) by adding at the end the following new paragraph:

"(5) ENTITIES TO WHICH PARAGRAPH APPLIES.—This paragraph applies to a corporation, trust, or association—

"(A) which is not a real estate investment trust to which the provisions of this part apply for the taxable year due to one or more failures to comply with one or more of the provisions of this part (other than subsection (c)(6) or (c)(7) of section 856),

"(B) such failures are due to reasonable cause and not due to willful neglect, and

"(C) if such corporation, trust, or association pays (as prescribed by the Secretary in regulations and in the same manner as tax) a penalty of $50,000 for each failure to satisfy a provision of this part due to reasonable cause and not willful neglect.".

(4) DEDUCTION OF TAX PAID FROM AMOUNT REQUIRED TO BE DISTRIBUTED.—Subparagraph (E) of section 857(b)(2) is amended by striking "(7)" and inserting "(7) of this subsection, section 856(c)(7)(B)(iii), and section 856(g)(1).".

(5) EXPANSION OF DEFICIENCY DIVIDEND PROCEDURE.—Subsection (e) of section 860 is amended by striking "or" at the end of paragraph (2), by striking the period at the end of paragraph (3) and inserting "; or", and by adding at the end the following new paragraph:

"(4) a statement by the taxpayer attached to its amendment or supplement to a return of tax for the relevant tax year.".

(g) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to taxable years beginning after December 31, 2000.

(2) SUBSECTIONS (c) THROUGH (f).—The amendments made by subsections (c), (d), (e), and (f) shall apply to taxable years beginning after the date of the enactment of this Act.

**SEC. 286. TREATMENT OF CERTAIN DIVIDENDS OF REGULATED INVESTMENT COMPANIES.**

(a) TREATMENT OF CERTAIN DIVIDENDS.—

(1) NONRESIDENT ALIEN INDIVIDUALS.—Section 871 (relating to tax on nonresident alien individuals) is amended by redesignating subsection (k) as subsection (l) and by inserting after subsection (j) the following new subsection:

"(k) EXEMPTION FOR CERTAIN DIVIDENDS OF REGULATED INVESTMENT COMPANIES.—

"(1) INTEREST-RELATED DIVIDENDS.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), no tax shall be imposed under paragraph (1)(A) of subsection (a) on any interest-related dividend received from a regulated investment company.

"(B) EXCEPTIONS.—Subparagraph (A) shall not apply—

"(i) to any interest-related dividend received from a regulated investment company by a person to the extent such dividend is attributable to interest (other than interest described in subparagraph (E) (i) or (iii)) received by such company on indebtedness issued by such person or by any corporation or partnership with respect to which such person is a 10-percent shareholder,

"(ii) to any interest-related dividend with respect to stock of a regulated investment company unless the person who would otherwise be required to deduct and withhold tax from such dividend under chapter 3 receives a statement (which meets requirements similar to the requirements of subsection (h)(5)) that the beneficial owner of such stock is not a United States person, and

"(iii) to any interest-related dividend paid to any person within a foreign country (or any interest-related dividend payment addressed to, or for the account of, persons within such foreign country) during any period described in subsection (h)(6) with respect to such country.

Clause (iii) shall not apply to any dividend with respect to any stock which was acquired on or before the date of the publication of the Secretary's determination under subsection (h)(6).

"(C) INTEREST-RELATED DIVIDEND.—For purposes of this paragraph, an interest-related dividend is any dividend (or part thereof) which is designated by the regulated investment company as an interest-related dividend in a written notice mailed to its shareholders not later than 60 days after the close of its taxable year. If the aggregate amount so designated with respect to a taxable year of the company (including amounts so designated with respect to dividends paid after the close of the taxable year described in section 855) is greater than the qualified net interest income of the company for such taxable year, the portion of each distribution which shall be an interest-related dividend shall be only that portion of the amounts so designated which such qualified net interest income bears to the aggregate amount so designated.

"(D) QUALIFIED NET INTEREST INCOME.—For purposes of subparagraph (C), the term 'qualified net interest income' means the qualified interest income of the regulated investment company reduced by the deductions properly allocable to such income.

"(E) QUALIFIED INTEREST INCOME.—For purposes of subparagraph (D), the term 'qualified interest income' means the sum of the following amounts derived by the regulated investment company from sources within the United States:

"(i) Any amount includible in gross income as original issue discount (within the meaning of section 1273) on an obligation payable 183 days or less from the date of original issue (without regard to the period held by the company).

"(ii) Any interest includible in gross income (including amounts recognized as ordinary income in respect of original issue discount or market discount or acquisition discount under part V of subchapter P and such other amounts as regulations may provide) on an obligation which is in registered form; except that this clause shall not apply to—

"(I) any interest on an obligation issued by a corporation or partnership if the regulated investment company is a 10-percent shareholder in such corporation or partnership, and

"(II) any interest which is treated as not being portfolio interest under the rules of subsection (h)(4).

"(iii) Any interest referred to in subsection (i)(2)(A) (without regard to the trade or business of the regulated investment company).

"(iv) Any interest-related dividend includable in gross income with respect to stock of another regulated investment company.

"(F) 10-PERCENT SHAREHOLDER.—For purposes of this paragraph, the term '10-percent shareholder' has the meaning given such term by subsection (h)(3)(B).

"(2) SHORT-TERM CAPITAL GAIN DIVIDENDS.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), no tax shall be imposed under paragraph (1)(A) of subsection (a) on any short-term capital gain dividend received from a regulated investment company.

"(B) EXCEPTION FOR ALIENS TAXABLE UNDER SUBSECTION (a)(2).—Subparagraph (A) shall not apply in the case of any nonresident alien individual subject to tax under subsection (a)(2).

"(C) SHORT-TERM CAPITAL GAIN DIVIDEND.—For purposes of this paragraph, a short-term capital gain dividend is any dividend (or part thereof) which is designated by the regulated investment company as a short-term capital gain dividend in a written notice mailed to its shareholders not later than 60 days after the close of its taxable year. If the aggregate amount so designated with respect to a taxable year of the company (including amounts so designated with respect to dividends paid after the close of the taxable year described in section 855) is greater than the qualified short-term gain of the company for such taxable year, the portion of each distribution which shall be a short-term capital gain dividend shall be only that portion of the amounts so designated which such qualified short-term gain bears to the aggregate amount so designated.

"(D) QUALIFIED SHORT-TERM GAIN.—For purposes of subparagraph (C), the term 'qualified short-term gain' means the excess of the net short-term capital gain of the regulated investment company for the taxable year over the net long-term capital loss (if any) of such company for such taxable year. For purposes of this subparagraph—

"(i) the net short-term capital gain of the regulated investment company shall be computed by treating any short-term capital gain dividend includible in gross income with respect to stock of another regulated investment company as a short-term capital gain, and

"(ii) the excess of the net short-term capital gain for a taxable year over the net long-term capital loss for a taxable year (to which an election under section 4982(e)(4) does not apply) shall be determined without regard to any net capital loss or net short-term capital loss attributable to transactions after October 31 of such year, and any such net capital loss or net short-term capital loss shall be treated as arising on the 1st day of the next taxable year.

To the extent provided in regulations, clause (ii) shall apply also for purposes of computing the taxable income of the regulated investment company."

(2) FOREIGN CORPORATIONS.—Section 881 (relating to tax on income of foreign corporations not connected with United States business) is amended by redesignating subsection (e) as subsection (f) and by inserting after subsection (d) the following new subsection:

"(e) TAX NOT TO APPLY TO CERTAIN DIVIDENDS OF REGULATED INVESTMENT COMPANIES.—

"(1) INTEREST-RELATED DIVIDENDS.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), no tax shall be imposed under paragraph (1) of subsection (a) on any interest-related dividend (as defined in section 871(k)(1)) received from a regulated investment company.

"(B) EXCEPTION.—Subparagraph (A) shall not apply—

"(i) to any dividend referred to in section 871(k)(1)(B), and

"(ii) to any interest-related dividend received by a controlled foreign corporation (within the meaning of section 957(a)) to the extent such dividend is attributable to interest received by the regulated investment company from a person who is a related person (within the meaning of section 864(d)(4)) with respect to such controlled foreign corporation.

"(C) TREATMENT OF DIVIDENDS RECEIVED BY CONTROLLED FOREIGN CORPORATIONS.—The rules of subsection (c)(5)(A) shall apply to any interest-related dividend received by a controlled foreign corporation (within the meaning of section 957(a)) to the extent such dividend is attributable to interest received by the regulated investment company which is described in clause (ii) of section 871(k)(1)(E) (and not described in clause (i) or (iii) of such section).

"(2) SHORT-TERM CAPITAL GAIN DIVIDENDS.—No tax shall be imposed under paragraph (1) of subsection (a) on any short-term capital gain dividend (as defined in section 871(k)(2)) received from a regulated investment company.".

(3) WITHHOLDING TAXES.—

(A) Section 1441(c) (relating to exceptions) is amended by adding at the end the following new paragraph:

"(12) CERTAIN DIVIDENDS RECEIVED FROM REGULATED INVESTMENT COMPANIES.—

"(A) IN GENERAL.—No tax shall be required to be deducted and withheld under subsection (a) from any amount exempt from the tax imposed by section 871(a)(1)(A) by reason of section 871(k).

"(B) SPECIAL RULE.—For purposes of subparagraph (A), clause (i) of section 871(k)(1)(B) shall not apply to any dividend unless the regulated investment company knows that such dividend is a dividend referred to in such clause. A similar rule shall apply with respect to the exception contained in section 871(k)(2)(B).".

(B) Section 1442(a) (relating to withholding of tax on foreign corporations) is amended—

(i) by striking "and the reference in section 1441(c)(10)" and inserting "the reference in section 1441(c)(10)", and

(ii) by inserting before the period at the end the following: ", and the references in section 1441(c)(12) to sections 871(a) and 871(k) shall be treated as referring to sections 881(a) and 881(e) (except that for purposes of applying subparagraph (A) of section 1441(c)(12), as so modified, clause (ii) of section 881(e)(1)(B) shall not apply to any dividend unless the regulated investment company knows that such dividend is a dividend referred to in such clause)".

(b) ESTATE TAX TREATMENT OF INTEREST IN CERTAIN REGULATED INVESTMENT COMPANIES.—Section 2105 (relating to property without the United States for estate tax purposes) is amended by adding at the end the following new subsection:

"(d) STOCK IN A RIC.—

"(1) IN GENERAL.—For purposes of this subchapter, stock in a regulated investment company (as defined in section 851) owned by a nonresident not a cit-

izen of the United States shall not be deemed property within the United States in the proportion that, at the end of the quarter of such investment company's taxable year immediately preceding a decedent's date of death (or at such other time as the Secretary may designate in regulations), the assets of the investment company that were qualifying assets with respect to the decedent bore to the total assets of the investment company.

"(2) QUALIFYING ASSETS.—For purposes of this subsection, qualifying assets with respect to a decedent are assets that, if owned directly by the decedent, would have been—

"(A) amounts, deposits, or debt obligations described in subsection (b) of this section,

"(B) debt obligations described in the last sentence of section 2104(c), or

"(C) other property not within the United States."

(c) TREATMENT OF REGULATED INVESTMENT COMPANIES UNDER SECTION 897.—

(1) Paragraph (1) of section 897(h) is amended by striking "REIT" each place it appears and inserting "qualified investment entity".

(2) Paragraphs (2) and (3) of section 897(h) are amended to read as follows:

"(2) SALE OF STOCK IN DOMESTICALLY CONTROLLED ENTITY NOT TAXED.—The term 'United States real property interest' does not include any interest in a domestically controlled qualified investment entity.

"(3) DISTRIBUTIONS BY DOMESTICALLY CONTROLLED QUALIFIED INVESTMENT ENTITIES.—In the case of a domestically controlled qualified investment entity, rules similar to the rules of subsection (d) shall apply to the foreign ownership percentage of any gain."

(3) Subparagraphs (A) and (B) of section 897(h)(4) are amended to read as follows:

"(A) QUALIFIED INVESTMENT ENTITY.—The term 'qualified investment entity' means any real estate investment trust and any regulated investment company.

"(B) DOMESTICALLY CONTROLLED.—The term 'domestically controlled qualified investment entity' means any qualified investment entity in which at all times during the testing period less than 50 percent in value of the stock was held directly or indirectly by foreign persons."

(4) Subparagraphs (C) and (D) of section 897(h)(4) are each amended by striking "REIT" and inserting "qualified investment entity".

(5) The subsection heading for subsection (h) of section 897 is amended by striking "REITS" and inserting "CERTAIN INVESTMENT ENTITIES".

(d) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall apply to dividends with respect to taxable years of regulated investment companies beginning after December 31, 2004.

(2) ESTATE TAX TREATMENT.—The amendment made by subsection (b) shall apply to estates of decedents dying after December 31, 2004.

(3) CERTAIN OTHER PROVISIONS.—The amendments made by subsection (c) (other than paragraph (1) thereof) shall take effect after December 31, 2004.

**SEC. 287. TAXATION OF CERTAIN SETTLEMENT FUNDS.**

(a) IN GENERAL.—Subsection (g) of section 468B (relating to clarification of taxation of certain funds) is amended to read as follows:

"(g) CLARIFICATION OF TAXATION OF CERTAIN FUNDS.—

"(1) IN GENERAL.—Except as provided in paragraph (2), nothing in any provision of law shall be construed as providing that an escrow account, settlement fund, or similar fund is not subject to current income tax. The Secretary shall prescribe regulations providing for the taxation of any such account or fund whether as a grantor trust or otherwise.

"(2) EXEMPTION FROM TAX FOR CERTAIN SETTLEMENT FUNDS.—An escrow account, settlement fund, or similar fund shall be treated as beneficially owned by the United States and shall be exempt from taxation under this subtitle if—

"(A) it is established pursuant to a consent decree entered by a judge of a United States District Court,

"(B) it is created for the receipt of settlement payments as directed by a government entity for the sole purpose of resolving or satisfying one or more claims asserting liability under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980,

"(C) the authority and control over the expenditure of funds therein (including the expenditure of contributions thereto and any net earnings thereon) is with such government entity, and

"(D) upon termination, any remaining funds will be disbursed to such government entity for use in accordance with applicable law.

For purposes of this paragraph, the term 'government entity' means the United States, any State or political subdivision thereof, the District of Columbia, any possession of the United States, and any agency or instrumentality of any of the foregoing.".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years beginning after December 31, 2004.

**SEC. 288. EXPANSION OF HUMAN CLINICAL TRIALS QUALIFYING FOR ORPHAN DRUG CREDIT.**

(a) IN GENERAL.—Paragraph (2) of section 45C(b) (relating to qualified clinical testing expenses) is amended by adding at the end the following new subparagraph:

"(C) TREATMENT OF CERTAIN EXPENSES INCURRED BEFORE DESIGNATION.—For purposes of subparagraph (A)(ii)(I), if a drug is designated under section 526 of the Federal Food, Drug, and Cosmetic Act not later than the due date (including extensions) for filing the return of tax under this subtitle for the taxable year in which the application for such designation of such drug was filed, such drug shall be treated as having been designated on the date that such application was filed.".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to expenses incurred after the date of the enactment of this Act.

**SEC. 289. SIMPLIFICATION OF EXCISE TAX IMPOSED ON BOWS AND ARROWS.**

(a) BOWS.—Paragraph (1) of section 4161(b) (relating to bows) is amended to read as follows:

"(1) BOWS.—

"(A) IN GENERAL.—There is hereby imposed on the sale by the manufacturer, producer, or importer of any bow which has a peak draw weight of 30 pounds or more, a tax equal to 11 percent of the price for which so sold.

"(B) ARCHERY EQUIPMENT.—There is hereby imposed on the sale by the manufacturer, producer, or importer—

"(i) of any part or accessory suitable for inclusion in or attachment to a bow described in subparagraph (A), and

"(ii) of any quiver or broadhead suitable for use with an arrow described in paragraph (2),

a tax equal to 11 percent of the price for which so sold.".

(b) ARROWS.—Subsection (b) of section 4161 (relating to bows and arrows, etc.) is amended by redesignating paragraph (3) as paragraph (4) and inserting after paragraph (2) the following:

"(3) ARROWS.—

"(A) IN GENERAL.—There is hereby imposed on the sale by the manufacturer, producer, or importer of any arrow, a tax equal to 12 percent of the price for which so sold.

"(B) EXCEPTION.—In the case of any arrow of which the shaft or any other component has been previously taxed under paragraph (1) or (2)—

"(i) section 6416(b)(3) shall not apply, and

"(ii) the tax imposed by subparagraph (A) shall be an amount equal to the excess (if any) of—

"(I) the amount of tax imposed by this paragraph (determined without regard to this subparagraph), over

"(II) the amount of tax paid with respect to the tax imposed under paragraph (1) or (2) on such shaft or component.

"(C) ARROW.—For purposes of this paragraph, the term 'arrow' means any shaft described in paragraph (2) to which additional components are attached.".

(c) CONFORMING AMENDMENTS.—Section 4161(b)(2) is amended—

(1) by inserting "(other than broadheads)" after "point", and

(2) by striking "ARROWS.—" in the heading and inserting "ARROW COMPONENTS.—".

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to articles sold by the manufacturer, producer, or importer after December 31, 2004.

**SEC. 290. REPEAL OF EXCISE TAX ON FISHING TACKLE BOXES.**

(a) REPEAL.—Paragraph (6) of section 4162(a) (defining sport fishing equipment) is amended by striking subparagraph (C) and by redesignating subparagraphs (D) through (J) as subparagraphs (C) through (I), respectively.

(b) EFFECTIVE DATE.—The amendments made this section shall apply to articles sold by the manufacturer, producer, or importer after December 31, 2004.

**SEC. 291. SONAR DEVICES SUITABLE FOR FINDING FISH.**

(a) NOT TREATED AS SPORT FISHING EQUIPMENT.—Subsection (a) of section 4162 (relating to sport fishing equipment defined) is amended by inserting "and" at the

end of paragraph (8), by striking ", and" at the end of paragraph (9) and inserting a period, and by striking paragraph (10).

(b) CONFORMING AMENDMENT.—Section 4162 is amended by striking subsection (b) and by redesignating subsection (c) as subsection (b).

(c) EFFECTIVE DATE.—The amendments made this section shall apply to articles sold by the manufacturer, producer, or importer after December 31, 2004.

**SEC. 292. INCOME TAX CREDIT TO DISTILLED SPIRITS WHOLESALERS FOR COST OF CARRYING FEDERAL EXCISE TAXES ON BOTTLED DISTILLED SPIRITS.**

(a) IN GENERAL.—Subpart A of part I of subchapter A of chapter 51 (relating to gallonage and occupational taxes) is amended by adding at the end the following new section:

**"SEC. 5011. INCOME TAX CREDIT FOR WHOLESALER'S AVERAGE COST OF CARRYING EXCISE TAX.**

"(a) IN GENERAL.—For purposes of section 38, in the case of an eligible wholesaler, the amount of the distilled spirits wholesalers credit for any taxable year is the amount equal to the product of—

"(1) the number of cases of bottled distilled spirits—

"(A) which were bottled in the United States, and

"(B) which are purchased by such wholesaler during the taxable year directly from the bottler of such spirits, and

"(2) the average tax-financing cost per case for the most recent calendar year ending before the beginning of such taxable year.

"(b) ELIGIBLE WHOLESALER.—For purposes of this section, the term 'eligible wholesaler' means any person who holds a permit under the Federal Alcohol Administration Act as a wholesaler of distilled spirits.

"(c) AVERAGE TAX-FINANCING COST.—

"(1) IN GENERAL.—For purposes of this section, the average tax-financing cost per case for any calendar year is the amount of interest which would accrue at the deemed financing rate during a 60-day period on an amount equal to the deemed Federal excise per case.

"(2) DEEMED FINANCING RATE.—For purposes of paragraph (1), the deemed financing rate for any calendar year is the average of the corporate overpayment rates under paragraph (1) of section 6621(a) (determined without regard to the last sentence of such paragraph) for calendar quarters of such year.

"(3) DEEMED FEDERAL EXCISE TAX BASED ON CASE.—For purposes of paragraph (1), the deemed Federal excise tax per case of 12 80-proof 750ml bottles is $22.83.

"(4) NUMBER OF CASES IN LOT.—For purposes of this section, the number of cases in any lot of distilled spirits shall be determined by dividing the number of liters in such lot by 9."

(b) CONFORMING AMENDMENTS.—

(1) Subsection (b) of section 38 is amended by striking "plus" at the end of paragraph (14), by striking the period at the end of paragraph (15) and inserting ", plus", and by adding at the end the following new paragraph:

"(16) in the case of an eligible wholesaler (as defined in section 5011(b)), the distilled spirits wholesalers credit determined under section 5011(a)."

(2) Subsection (d) of section 39 (relating to carryback and carryforward of unused credits) is amended by adding at the end the following new paragraph:

"(11) NO CARRYBACK OF SECTION 5011 CREDIT BEFORE JANUARY 1, 2005.—No portion of the unused business credit for any taxable year which is attributable to the credit determined under section 5011(a) may be carried back to a taxable year beginning before January 1, 2005.".

(3) The table of sections for subpart A of part I of subchapter A of chapter 51 is amended by adding at the end the following new item:

"Sec. 5011. Income tax credit for wholesaler's average cost of carrying excise tax.".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2004.

**SEC. 293. SUSPENSION OF OCCUPATIONAL TAXES RELATING TO DISTILLED SPIRITS, WINE, AND BEER.**

(a) IN GENERAL.—Subpart G of part II of subchapter A of chapter 51 is amended by redesignating section 5148 as section 5149 and by inserting after section 5147 the following new section:

**"SEC. 5148. SUSPENSION OF OCCUPATIONAL TAX.**

"(a) IN GENERAL.—Notwithstanding sections 5081, 5091, 5111, 5121, and 5131, the rate of tax imposed under such sections for the suspension period shall be zero. During such period, persons engaged in or carrying on a trade or business covered

by such sections shall register under section 5141 and shall comply with the recordkeeping requirements under this part.

"(b) SUSPENSION PERIOD.—For purposes of subsection (a), the suspension period is the period beginning on July 1, 2004, and ending on June 30, 2007.".

(b) CONFORMING AMENDMENT.—Section 5117 is amended by adding at the end the following new subsection:

"(d) SPECIAL RULE DURING SUSPENSION PERIOD.—Except as provided in subsection (b) or by the Secretary, during the suspension period (as defined in section 5148) it shall be unlawful for any dealer to purchase distilled spirits for resale from any person other than a wholesale dealer in liquors who is required to keep records under section 5114.".

(c) CLERICAL AMENDMENT.—The table of sections for subpart G of part II of subchapter A of chapter 51 is amended by striking the last item and inserting the following new items:

"Sec. 5148. Suspension of occupational tax.
"Sec. 5149. Cross references.".

(d) EFFECTIVE DATE.—The amendments made by this section shall take effect on the date of the enactment of this Act.

**SEC. 294. MODIFICATION OF UNRELATED BUSINESS INCOME LIMITATION ON INVESTMENT IN CERTAIN SMALL BUSINESS INVESTMENT COMPANIES.**

(a) IN GENERAL.—Paragraph (6) of section 514(c) (relating to acquisition indebtedness) is amended to read as follows:

"(6) CERTAIN FEDERAL FINANCING.—

"(A) IN GENERAL.—For purposes of this section, the term 'acquisition indebtedness' does not include—

"(i) an obligation, to the extent that it is insured by the Federal Housing Administration, to finance the purchase, rehabilitation, or construction of housing for low and moderate income persons, or

"(ii) indebtedness incurred by a small business investment company licensed under the Small Business Investment Act of 1958 and formed after the date of the enactment of the American Jobs Creation Act of 2004, if such indebtedness is evidenced by a debenture—

"(I) issued by such company under section 303(a) of such Act, and

"(II) held or guaranteed by the Small Business Administration.

"(B) LIMITATION.—Subparagraph (A)(ii) shall not apply with respect to any small business investment company during any period that—

"(i) any organization which is exempt from tax under this title (other than a governmental unit) owns more than 25 percent of the capital or profits interest in such company, or

"(ii) organizations which are exempt from tax under this title (including governmental units other than any agency or instrumentality of the United States) own, in the aggregate, 50 percent or more of the capital or profits interest in such company.".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to indebtedness incurred by small business investment companies formed after the date of the enactment of the American Jobs Creation Act of 2004.

**SEC. 295. ELECTION TO DETERMINE TAXABLE INCOME FROM CERTAIN INTERNATIONAL SHIPPING ACTIVITIES USING PER TON RATE.**

(a) IN GENERAL.—Chapter 1 of the Internal Revenue Code of 1986 is amended by inserting after subchapter Q the following new subchapter:

## "Subchapter R—Election To Determine Taxable Income From Certain International Shipping Activities Using per Ton Rate

"Sec. 1352. Alternative tax on qualifying shipping activities.
"Sec. 1353. Taxable income from qualifying shipping activities.
"Sec. 1354. Qualifying shipping tax election; revocation; termination.
"Sec. 1355. Definitions and special rules.
"Sec. 1356. Qualifying shipping activities.
"Sec. 1357. Items not subject to regular tax; depreciation; interest.
"Sec. 1358. Allocation of credits, income, and deductions.
"Sec. 1359. Disposition of qualifying shipping assets.

**"SEC. 1352. ALTERNATIVE TAX ON QUALIFYING SHIPPING ACTIVITIES.**

"(a) IN GENERAL.—The taxable income of an electing corporation from qualifying shipping activities shall be the amount determined under this subchapter, and the corporate percentages of the items of income, gain, loss, deduction, or credit of an electing corporation and of other members of the electing group of such corporation which would otherwise be taken into account by reason of its qualifying shipping activities shall be taken into account to the extent provided in section 1357.

"(b) ALTERNATIVE TAX.—The taxable income of an electing corporation from qualifying shipping activities, if otherwise taxable under section 11, 55, 882, 887, or 1201(a) shall be subject to tax only under this section at the maximum rate specified in section 11(b). The income of a foreign corporation shall not be subject to tax under this subchapter to the extent its income is excludible from gross income under section 883(a)(1).

**"SEC. 1353. TAXABLE INCOME FROM QUALIFYING SHIPPING ACTIVITIES.**

"(a) IN GENERAL.—For purposes of this subchapter, the taxable income of an electing corporation from qualifying shipping activities shall be its corporate income percentage of the sum of the amounts determined under subsection (b) for each qualifying vessel operated by such electing corporation or other electing entity.

"(b) AMOUNTS.—For purposes of subsection (a), the amount of taxable income of an electing entity for each qualifying vessel shall equal the product of—

"(1) the daily notional taxable income from the operation of the qualifying vessel in United States foreign trade, and

"(2) the number of days during the taxable year that the electing entity operated such vessel as a qualifying vessel in United States foreign trade.

"(c) DAILY NOTIONAL TAXABLE INCOME.—For purposes of subsection (b), the daily notional taxable income from the operation of a qualifying vessel is 40 cents for each 100 tons of the net tonnage of the vessel, up to 25,000 net tons, and 20 cents for each 100 tons of the net tonnage of the vessel, in excess of 25,000 net tons.

"(d) MULTIPLE OPERATORS OF VESSEL.—If 2 or more persons have a joint interest in a qualifying vessel and are treated as operators of that vessel, the taxable income from the operation of such vessel for that time (as determined under this section) shall be allocated among such persons on the basis of their ownership and charter interests in such vessel or on such other basis as the Secretary may prescribe by regulations.

"(e) NONCORPORATE PERCENTAGE.—Notwithstanding any contrary provision of this subchapter, the noncorporate percentage of any item of income, gain, loss, deduction, or credit of any member of an electing group shall be taken into account for all purposes of this subtitle as if this subchapter were not in effect.

**"SEC. 1354. QUALIFYING SHIPPING TAX ELECTION; REVOCATION; TERMINATION.**

"(a) IN GENERAL.—Except as provided in subsections (b) and (f), a qualifying shipping tax election may be made in respect of any qualifying entity.

"(b) CONDITION OF ELECTION.—An election may be made by a member of a controlled group under this subsection for any taxable year only if all qualifying entities that are members of the controlled group join in the election.

"(c) WHEN MADE.—An election under subsection (a) may be made by a qualifying entity in such form as prescribed by the Secretary. Such election shall be filed with the qualifying entity's return for the first taxable year to which the election shall apply, by the due date for such return (including any applicable extensions).

"(d) YEARS FOR WHICH EFFECTIVE.—An election under subsection (a) shall be effective for the taxable year of the qualifying entity for which it is made and for all succeeding taxable years of the entity, until such election is terminated under subsection (e).

"(e) TERMINATION.—

"(1) BY REVOCATION.—

"(A) IN GENERAL.—An election under subsection (a) may be terminated by revocation.

"(B) WHEN EFFECTIVE.—Except as provided in subparagraph (C)—

"(i) a revocation made during the taxable year and on or before the 15th day of the 3rd month thereof shall be effective on the 1st day of such taxable year, and

"(ii) a revocation made during the taxable year but after such 15th day shall be effective on the 1st day of the following taxable year.

"(C) REVOCATION MAY SPECIFY PROSPECTIVE DATE.—If the revocation specifies a date for revocation which is on or after the day on which the revocation is made, the revocation shall be effective on and after the date so specified.

"(2) BY ENTITY CEASING TO BE QUALIFYING ENTITY.—

"(A) IN GENERAL.—An election under subsection (a) shall be terminated whenever (at any time on or after the 1st day of the 1st taxable year for which the entity is an electing entity) such entity ceases to be a qualifying entity.

"(B) WHEN EFFECTIVE.—Any termination under this paragraph shall be effective on and after the date of cessation.

"(f) ELECTION AFTER TERMINATION.—If a qualifying entity has made an election under subsection (a) and if such election has been terminated under subsection (e),

such entity (and any successor entity) shall not be eligible to make an election under subsection (a) for any taxable year before its 5th taxable year which begins after the 1st taxable year for which such termination is effective, unless the Secretary consents to such election.

**"SEC. 1355. DEFINITIONS AND SPECIAL RULES.**

"(a) DEFINITIONS.—For purposes of this subchapter:

"(1) The term 'controlled group' means any group of trusts and business entities whose members would be treated as a single employer under the rules of section 52(a) (without regard to paragraphs (1) and (2) thereof) and section 52(b)(1).

"(2) The term 'corporate income percentage' means the least aggregate share, expressed as a percentage, of any item of income or gain of an electing corporation or electing group of which such corporation is a member from qualifying shipping activities that would, but for an election in effect under this subchapter, be required to be reported on the Federal income tax return of an electing corporation during any taxable period. In the case of an electing group which includes two or more electing corporations, the corporate income percentage of each such corporation shall be determined on the basis of such corporations' direct and indirect ownership and charter interests in qualifying vessels of the electing group or on such other basis as the Secretary may prescribe by regulations.

"(3) The term 'corporate loss percentage' means the greatest aggregate share, expressed as a percentage, of any item of loss, deduction or credit of an electing corporation or electing group of which such corporation is a member from qualifying shipping activities that would, but for an election in effect under this subchapter, be required to be reported on the Federal income tax return of an electing corporation during any taxable period.

"(4) The term 'corporate percentages' means the corporate income percentage and the corporate loss percentage.

"(5) The term 'electing corporation' means any C corporation that is an electing entity or that would, but for an election in effect under this subchapter, be required to report any item of income, gain, loss, deduction, or credit of an electing entity on its Federal income tax return.

"(6) The term 'electing entity' means any qualifying entity for which an election is in effect under this subchapter.

"(7) The term 'electing group' means a controlled group of which one or more members is an electing entity.

"(8) The term 'noncorporate percentage' means the difference between one hundred percent and the corporate income percentage or corporate loss percentage, as applicable.

"(9) The term 'qualifying entity' means a trust or business entity that—

"(A) operates one or more qualifying vessels, and

"(B) meets the shipping activity requirement in subsection (c).

"(10) The term 'qualifying shipping assets' means any qualifying vessel and other assets which are used in core qualifying activities as described in section 1356(b).

"(11) The term 'qualifying vessel' means a self-propelled (or a combination self-propelled and non-self-propelled) United States flag vessel of not less than 10,000 deadweight tons used in the United States foreign trade.

"(12) The term 'United States domestic trade' means the transportation of goods or passengers between places in the United States.

"(13) The term 'United States flag vessel' means any vessel documented under the laws of the United States.

"(14) The term 'United States foreign trade' means the transportation of goods or passengers between a place in the United States and a foreign place or between foreign places.

"(b) OPERATING A VESSEL.—For purposes of this subchapter:

"(1) Except as provided in paragraph (2), an entity is treated as operating any vessel owned by, or chartered (including a time charter) to, the entity.

"(2) An entity is treated as operating a vessel that it has chartered out on bareboat charter terms only if—

"(A) the vessel is temporarily surplus to the entity's requirements and the term of the charter does not exceed three years; or

"(B) the vessel is bareboat chartered to a member of a controlled group which includes such entity or to an unrelated third party that sub-bareboats or time charters the vessel to a member of such controlled group (including the owner).

"(c) SHIPPING ACTIVITY REQUIREMENT.—For purposes of this section, the shipping activity requirement is met for a taxable year only by an entity described in paragraph (1), (2), or (3).

"(1) An entity in the first taxable year of its qualifying shipping tax election if, for the preceding taxable year, the test in paragraph (4) is met.

"(2) An entity in the second or any subsequent taxable year of its qualifying shipping tax election if, for each of the two preceding taxable years, the test in paragraph (4) is met.

"(3) An entity that would be described in paragraph (1) or (2) if the test in paragraph (4) were applied on an aggregate basis to the controlled group of which such entity is a member, and vessel charters between members of the controlled group were disregarded.

"(4) The test in this paragraph is met if on average at least 25 percent of the aggregate tonnage of qualifying vessels operated by the entity were owned by the entity or chartered to the entity on bareboat charter terms. For purposes of the preceding sentence, vessels chartered (including time chartered) to an entity by a member of a controlled group which includes the entity, or by a third party that bareboat charters the vessels from the entity or a member of the entity's controlled group, shall be treated as chartered to the entity on bareboat charter terms.

"(d) EFFECT OF TEMPORARILY CEASING TO OPERATE A QUALIFYING VESSEL.—

"(1) A temporary cessation by an electing entity in operation of a qualifying vessel shall be disregarded for purposes of subsections (b) and (c) if the electing entity gives timely notice to the Secretary stating—

"(A) that it has temporarily ceased to operate the qualifying vessel, and

"(B) its intention to resume operating the qualifying vessel.

"(2) Notice shall be deemed timely if given not later than the due date (including extensions) for the electing entity's tax return (as set forth in section 6072(b)) for the taxable year in which the temporary cessation begins.

"(3) The treatment provided by paragraph (1) shall continue until the earlier of—

"(A) the electing entity abandoning its intention to resume operation of the qualifying vessel, or

"(B) the electing entity resuming operation of the qualifying vessel.

"(e) EFFECT OF TEMPORARILY OPERATING A QUALIFYING VESSEL IN THE UNITED STATES DOMESTIC TRADE.—

"(1) The temporary operation in the United States domestic trade of any qualifying vessel which had been used in the United States foreign trade shall be disregarded for purposes of this subchapter if the electing entity gives timely notice to the Secretary stating—

"(A) that it temporarily operates or has operated in the United States domestic trade a qualifying vessel which had been used in the United States foreign trade, and

"(B) its intention to resume operation of the vessel in the United States foreign trade.

"(2) Notice shall be deemed timely if given not later than the due date (including extensions) for the electing entity's tax return (as set forth in section 6072(b)) for the taxable year in which the temporary cessation begins.

"(3) The treatment provided by paragraph (1) shall continue until the earlier of—

"(A) the electing entity abandoning its intention to resume operations of the vessel in the United States foreign trade, or

"(B) the electing entity resuming operation of the vessel in the United States foreign trade.

"(f) EFFECT OF CHANGE IN USE.—

"(1) Except as provided in subsection (e), a vessel that is used other than for operations in the United States foreign trade on other than a temporary basis ceases to be a qualifying vessel when such use begins.

"(2) For purposes of this subsection, a change in use of a vessel, other than a commencement of operation in the United States domestic trade, is taken to be permanent unless there are circumstances indicating that it is temporary.

"(g) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section.

**"SEC. 1356. QUALIFYING SHIPPING ACTIVITIES.**

"(a) QUALIFYING SHIPPING ACTIVITIES.—For purposes of this subchapter the 'qualifying shipping activities' of an electing entity consist of—

"(1) core qualifying activities,

"(2) qualifying secondary activities, and

"(3) qualifying incidental activities.

"(b) CORE QUALIFYING ACTIVITIES.—

"(1) The 'core qualifying activities' of an electing entity are—

"(A) its activities in operating qualifying vessels in United States foreign trade, and

"(B) other activities of the electing entity and other members of its electing group that are an integral part of its business of operating qualifying vessels in United States foreign trade, including ownership or operation of barges, containers, chassis, and other equipment that are the complement of, or used in connection with, a qualifying vessel in United States foreign trade, the inland haulage of cargo shipped, or to be shipped, on qualifying vessels in United States foreign trade, and the provision of terminal, maintenance, repair, logistical, or other vessel, container, or cargo-related services that are an integral part of operating qualifying vessels in United States foreign trade.

"(2) 'Core qualifying activities' do not include the provision by an entity of facilities or services to any person, other than—

"(A) another member of such entity's electing group,

"(B) a consignor, consignee, or other customer of such entity's business of operating qualifying vessels in United States foreign trade, or

"(C) a member of an alliance, joint venture, pool, partnership or similar undertaking involving the operation of qualifying vessels in United States foreign trade of which such entity is a member.

"(c) QUALIFYING SECONDARY ACTIVITIES.—For purposes of this subsection—

"(1) the term 'secondary activities' means activities that are not core qualifying activities, and—

"(A) are the active management or operation of vessels in the United States foreign trade,

"(B) the provision of vessel, container, or cargo-related facilities or services to any person, or

"(C) such other activities as may be prescribed by the Secretary pursuant to regulations, and

"(2) the 'qualified secondary activities' of an electing entity are its secondary activities and the secondary activities of other members of its electing group, but only to the extent that, without regard to this subchapter, the aggregate gross income derived by the electing entity and the other members of its electing group from such activities does not exceed 20 percent of the aggregate gross income derived by the electing entity and the other members of its electing group from their core qualifying activities.

"(d) QUALIFYING INCIDENTAL ACTIVITIES.—Shipping-related activities carried on by an electing entity or another member of its electing group are qualified incidental activities of the electing entity if—

"(1) incidental to its core qualifying activities,

"(2) not qualifying secondary activities, and

"(3) without regard to this subchapter, the aggregate gross income derived by the electing entity and other members of its electing group from such activities does not exceed 0.1 percent of such entities' aggregate gross income from their core qualifying activities.

**"SEC. 1357. ITEMS NOT SUBJECT TO REGULAR TAX; DEPRECIATION; INTEREST.**

"(a) EXCLUSION FROM GROSS INCOME.—Gross income of an electing entity shall not include the corporate income percentage of—

"(1) income from qualifying shipping activities in the United States foreign trade,

"(2) income from money, bank deposits and other temporary investments which are reasonably necessary to meet the working capital requirements of qualifying shipping activities, and

"(3) income from money or other intangible assets accumulated pursuant to a plan to purchase qualifying shipping assets.

"(b) ELECTING GROUP MEMBER.—Gross income of a member of an electing group that is not an electing entity shall not include the corporate income percentage of its income from qualifying shipping activities that are taken into account under this subchapter as qualifying shipping activities of an electing entity.

"(c) DENIAL OF LOSSES, DEDUCTIONS, AND CREDITS.—

"(1) GENERAL RULE.—Subject to paragraph (2), the corporate loss percentage of each item of loss, deduction (other than for interest expense), or credit of any taxpayer with respect to any activity the income from which is excluded from gross income under this section shall be disallowed.

"(2) DEPRECIATION.—Notwithstanding paragraph (1), the deduction for depreciation of a qualifying shipping asset shall be allowed in determining the adjusted basis of such asset for purposes of determining gain from its disposition.

"(A) Except as provided in subparagraph (B), the straight line method of depreciation shall apply to the corporate income percentage of qualifying shipping assets the income from operation of which is excluded from gross income under this section.

"(B) Subparagraph (A) shall not apply to any qualifying shipping asset which is subject to a charter entered into prior to the effective date of this subchapter.

"(3) INTEREST.—The corporate loss percentage of an electing entity's interest expense shall be disallowed in the ratio that the fair market value of its qualifying vessel assets bears to the fair market value of its total assets.

"(d) SECTION INAPPLICABLE TO UNRELATED PERSONS.—This section shall not apply to a taxpayer that is not a member of an electing group.

**"SEC. 1358. ALLOCATION OF CREDITS, INCOME, AND DEDUCTIONS.**

"(a) QUALIFYING SHIPPING ACTIVITIES.—For purposes of this chapter, the qualifying shipping activities of an electing entity shall be treated as a separate trade or business activity from all other activities conducted by the entity.

"(b) EXCLUSION OF CREDITS OR DEDUCTIONS.—

"(1) No deduction shall be allowed against the taxable income of an electing corporation from qualifying shipping activities, and no credit shall be allowed against the tax imposed by section 1352(b).

"(2) No deduction shall be allowed for any net operating loss attributable to the qualifying shipping activities of a corporation to the extent that such loss is carried forward by the corporation from a taxable year preceding the first taxable year for which such corporation was an electing corporation.

"(c) TRANSACTIONS NOT AT ARM'S LENGTH.—Section 482 shall apply in accordance with this subsection to a transaction or series of transactions—

"(1) as between an electing entity and another person, or

"(2) as between an entity's qualifying shipping activities and other activities carried on by it.

**"SEC. 1359. DISPOSITION OF QUALIFYING SHIPPING ASSETS.**

"(a) IN GENERAL.—If an electing entity sells or disposes of qualifying shipping assets (as defined in subsection (c)) in an otherwise taxable transaction, at the election of the entity no gain shall be recognized if replacement qualifying shipping assets are acquired during the period specified in subsection (b), except to the extent that the amount realized upon such sale or disposition exceeds the cost of the replacement qualifying shipping assets.

"(b) PERIOD WITHIN WHICH PROPERTY MUST BE REPLACED.—The period referred to in subsection (a) shall be the period beginning one year prior to the disposition of the qualifying shipping assets and ending—

"(1) 3 years after the close of the first taxable year in which the gain is realized, or

"(2) subject to such terms and conditions as may be specified by the Secretary, on such later date as the Secretary may designate on application by the taxpayer. Such application shall be made at such time and in such manner as the Secretary may by regulations prescribe.

"(c) TIME FOR ASSESSMENT OF DEFICIENCY ATTRIBUTABLE TO GAIN.—If an electing entity has made the election provided in subsection (a), then—

"(1) the statutory period for the assessment of any deficiency, for any taxable year in which any part of the gain is realized, attributable to such gain shall not expire prior to the expiration of 3 years from the date the Secretary is notified by the entity (in such manner as the Secretary may by regulations prescribe) of the replacement tonnage tax property or of an intention not to replace, and

"(2) such deficiency may be assessed before the expiration of such 3-year period notwithstanding the provisions of section 6212(c) or the provisions of any other law or rule of law which would otherwise prevent such assessment.

"(d) BASIS OF REPLACEMENT QUALIFYING SHIPPING ASSETS.—In the case of replacement qualifying shipping assets purchased by an electing entity which resulted in the nonrecognition of any part of the gain realized as the result of a sale or other disposition of qualifying shipping assets, the basis shall be the cost of such property decreased in the amount of the gain not so recognized; and if the property purchased consists of more than one piece of property, the basis determined under this sentence shall be allocated to the purchased properties in proportion to their respective costs.

"(e) REPLACEMENT QUALIFYING SHIPPING ASSETS MUST BE ACQUIRED FROM UNRELATED PERSON IN CERTAIN CASES.—

"(1) IN GENERAL.—Subsection (a) shall not apply if the replacement qualifying shipping assets are acquired from a related person except to the extent that the related person acquired the replacement qualifying shipping assets from an unrelated person during the period applicable under subsection (b).

"(2) RELATED PERSON.—For purposes of this subsection, a person is related to another person if the person bears a relationship to the other person described in section 267(b) or 707(b)(1)."

(b) TECHNICAL AND CONFORMING AMENDMENT.—The second sentence of section 56(g)(4)(B)(i), as amended by this Act, is further amended by inserting "or 1357" after "section 139A".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

**SEC. 296. CHARITABLE CONTRIBUTION DEDUCTION FOR CERTAIN EXPENSES INCURRED IN SUPPORT OF NATIVE ALASKAN SUBSISTENCE WHALING.**

(a) IN GENERAL.—Section 170 (relating to charitable, etc., contributions and gifts), as amended by this Act, is amended by redesignating subsection (n) as subsection (o) and by inserting after subsection (m) the following new subsection:

"(n) EXPENSES PAID BY CERTAIN WHALING CAPTAINS IN SUPPORT OF NATIVE ALASKAN SUBSISTENCE WHALING.—

"(1) IN GENERAL.—In the case of an individual who is recognized by the Alaska Eskimo Whaling Commission as a whaling captain charged with the responsibility of maintaining and carrying out sanctioned whaling activities and who engages in such activities during the taxable year, the amount described in paragraph (2) (to the extent such amount does not exceed $10,000 for the taxable year) shall be treated for purposes of this section as a charitable contribution.

"(2) AMOUNT DESCRIBED.—

"(A) IN GENERAL.—The amount described in this paragraph is the aggregate of the reasonable and necessary whaling expenses paid by the taxpayer during the taxable year in carrying out sanctioned whaling activities.

"(B) WHALING EXPENSES.—For purposes of subparagraph (A), the term 'whaling expenses' includes expenses for—

"(i) the acquisition and maintenance of whaling boats, weapons, and gear used in sanctioned whaling activities,

"(ii) the supplying of food for the crew and other provisions for carrying out such activities, and

"(iii) storage and distribution of the catch from such activities.

"(3) SANCTIONED WHALING ACTIVITIES.—For purposes of this subsection, the term 'sanctioned whaling activities' means subsistence bowhead whale hunting activities conducted pursuant to the management plan of the Alaska Eskimo Whaling Commission.".

(b) EFFECTIVE DATE.—The amendments made by subsection (a) shall apply to contributions made after December 31, 2004.

# TITLE III—TAX REFORM AND SIMPLIFICATION FOR UNITED STATES BUSINESSES

**SEC. 301. INTEREST EXPENSE ALLOCATION RULES.**

(a) ELECTION TO ALLOCATE ON WORLDWIDE BASIS.—Section 864 is amended by redesignating subsection (f) as subsection (g) and by inserting after subsection (e) the following new subsection:

"(f) ELECTION TO ALLOCATE INTEREST, ETC. ON WORLDWIDE BASIS.—For purposes of this subchapter, at the election of the worldwide affiliated group—

"(1) ALLOCATION AND APPORTIONMENT OF INTEREST EXPENSE.—

"(A) IN GENERAL.—The taxable income of each domestic corporation which is a member of a worldwide affiliated group shall be determined by allocating and apportioning interest expense of each member as if all members of such group were a single corporation.

"(B) TREATMENT OF WORLDWIDE AFFILIATED GROUP.—The taxable income of the domestic members of a worldwide affiliated group from sources outside the United States shall be determined by allocating and apportioning the interest expense of such domestic members to such income in an amount equal to the excess (if any) of—

"(i) the total interest expense of the worldwide affiliated group multiplied by the ratio which the foreign assets of the worldwide affiliated group bears to all the assets of the worldwide affiliated group, over

"(ii) the interest expense of all foreign corporations which are members of the worldwide affiliated group to the extent such interest expense of such foreign corporations would have been allocated and apportioned to foreign source income if this subsection were applied to a group consisting of all the foreign corporations in such worldwide affiliated group.

"(C) WORLDWIDE AFFILIATED GROUP.—For purposes of this paragraph, the term 'worldwide affiliated group' means a group consisting of—

"(i) the includible members of an affiliated group (as defined in section 1504(a), determined without regard to paragraphs (2) and (4) of section 1504(b)), and

"(ii) all controlled foreign corporations in which such members in the aggregate meet the ownership requirements of section 1504(a)(2) either directly or indirectly through applying paragraph (2) of section 958(a) or through applying rules similar to the rules of such paragraph to stock owned directly or indirectly by domestic partnerships, trusts, or estates.

"(2) ALLOCATION AND APPORTIONMENT OF OTHER EXPENSES.—Expenses other than interest which are not directly allocable or apportioned to any specific income producing activity shall be allocated and apportioned as if all members of the affiliated group were a single corporation. For purposes of the preceding sentence, the term 'affiliated group' has the meaning given such term by section 1504 (determined without regard to paragraph (4) of section 1504(b)).

"(3) TREATMENT OF TAX-EXEMPT ASSETS; BASIS OF STOCK IN NONAFFILIATED 10-PERCENT OWNED CORPORATIONS.—The rules of paragraphs (3) and (4) of subsection (e) shall apply for purposes of this subsection, except that paragraph (4) shall be applied on a worldwide affiliated group basis.

"(4) TREATMENT OF CERTAIN FINANCIAL INSTITUTIONS.—

"(A) IN GENERAL.—For purposes of paragraph (1), any corporation described in subparagraph (B) shall be treated as an includible corporation for purposes of section 1504 only for purposes of applying this subsection separately to corporations so described.

"(B) DESCRIPTION.—A corporation is described in this subparagraph if—

"(i) such corporation is a financial institution described in section 581 or 591,

"(ii) the business of such financial institution is predominantly with persons other than related persons (within the meaning of subsection (d)(4)) or their customers, and

"(iii) such financial institution is required by State or Federal law to be operated separately from any other entity which is not such an institution.

"(C) TREATMENT OF BANK AND FINANCIAL HOLDING COMPANIES.—To the extent provided in regulations—

"(i) a bank holding company (within the meaning of section 2(a) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(a)),

"(ii) a financial holding company (within the meaning of section 2(p) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(p)), and

"(iii) any subsidiary of a financial institution described in section 581 or 591, or of any such bank or financial holding company, if such subsidiary is predominantly engaged (directly or indirectly) in the active conduct of a banking, financing, or similar business,

shall be treated as a corporation described in subparagraph (B).

"(5) ELECTION TO EXPAND FINANCIAL INSTITUTION GROUP OF WORLDWIDE GROUP.—

"(A) IN GENERAL.—If a worldwide affiliated group elects the application of this subsection, all financial corporations which—

"(i) are members of such worldwide affiliated group, but

"(ii) are not corporations described in paragraph (4)(B),

shall be treated as described in paragraph (4)(B) for purposes of applying paragraph (4)(A). This subsection (other than this paragraph) shall apply to any such group in the same manner as this subsection (other than this paragraph) applies to the pre-election worldwide affiliated group of which such group is a part.

"(B) FINANCIAL CORPORATION.—For purposes of this paragraph, the term 'financial corporation' means any corporation if at least 80 percent of its gross income is income described in section 904(d)(2)(C)(ii) and the regula-

tions thereunder which is derived from transactions with persons who are not related (within the meaning of section 267(b) or 707(b)(1)) to the corporation. For purposes of the preceding sentence, there shall be disregarded any item of income or gain from a transaction or series of transactions a principal purpose of which is the qualification of any corporation as a financial corporation.

"(C) ANTIABUSE RULES.—In the case of a corporation which is a member of an electing financial institution group, to the extent that such corporation—

"(i) distributes dividends or makes other distributions with respect to its stock after the date of the enactment of this paragraph to any member of the pre-election worldwide affiliated group (other than to a member of the electing financial institution group) in excess of the greater of—

"(I) its average annual dividend (expressed as a percentage of current earnings and profits) during the 5-taxable-year period ending with the taxable year preceding the taxable year, or

"(II) 25 percent of its average annual earnings and profits for such 5-taxable-year period, or

"(ii) deals with any person in any manner not clearly reflecting the income of the corporation (as determined under principles similar to the principles of section 482),

an amount of indebtedness of the electing financial institution group equal to the excess distribution or the understatement or overstatement of income, as the case may be, shall be recharacterized (for the taxable year and subsequent taxable years) for purposes of this paragraph as indebtedness of the worldwide affiliated group (excluding the electing financial institution group). If a corporation has not been in existence for 5 taxable years, this subparagraph shall be applied with respect to the period it was in existence.

"(D) ELECTION.—An election under this paragraph with respect to any financial institution group may be made only by the common parent of the pre-election worldwide affiliated group and may be made only for the first taxable year beginning after December 31, 2008, in which such affiliated group includes 1 or more financial corporations. Such an election, once made, shall apply to all financial corporations which are members of the electing financial institution group for such taxable year and all subsequent years unless revoked with the consent of the Secretary.

"(E) DEFINITIONS RELATING TO GROUPS.—For purposes of this paragraph—

"(i) PRE-ELECTION WORLDWIDE AFFILIATED GROUP.—The term 'pre-election worldwide affiliated group' means, with respect to a corporation, the worldwide affiliated group of which such corporation would (but for an election under this paragraph) be a member for purposes of applying paragraph (1).

"(ii) ELECTING FINANCIAL INSTITUTION GROUP.—The term 'electing financial institution group' means the group of corporations to which this subsection applies separately by reason of the application of paragraph (4)(A) and which includes financial corporations by reason of an election under subparagraph (A).

"(F) REGULATIONS.—The Secretary shall prescribe such regulations as may be appropriate to carry out this subsection, including regulations—

"(i) providing for the direct allocation of interest expense in other circumstances where such allocation would be appropriate to carry out the purposes of this subsection,

"(ii) preventing assets or interest expense from being taken into account more than once, and

"(iii) dealing with changes in members of any group (through acquisitions or otherwise) treated under this paragraph as an affiliated group for purposes of this subsection.

"(6) ELECTION.—An election to have this subsection apply with respect to any worldwide affiliated group may be made only by the common parent of the domestic affiliated group referred to in paragraph (1)(C) and may be made only for the first taxable year beginning after December 31, 2008, in which a worldwide affiliated group exists which includes such affiliated group and at least 1 foreign corporation. Such an election, once made, shall apply to such common parent and all other corporations which are members of such worldwide affiliated group for such taxable year and all subsequent years unless revoked with the consent of the Secretary.".

(b) EXPANSION OF REGULATORY AUTHORITY.—Paragraph (7) of section 864(e) is amended—

(1) by inserting before the comma at the end of subparagraph (B) "and in other circumstances where such allocation would be appropriate to carry out the purposes of this subsection", and

(2) by striking "and" at the end of subparagraph (E), by redesignating subparagraph (F) as subparagraph (G), and by inserting after subparagraph (E) the following new subparagraph:

"(F) preventing assets or interest expense from being taken into account more than once, and".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2008.

**SEC. 302. RECHARACTERIZATION OF OVERALL DOMESTIC LOSS.**

(a) GENERAL RULE.—Section 904 is amended by redesignating subsections (g), (h), (i), (j), and (k) as subsections (h), (i), (j), (k), and (l) respectively, and by inserting after subsection (f) the following new subsection:

"(g) RECHARACTERIZATION OF OVERALL DOMESTIC LOSS.—

"(1) GENERAL RULE.—For purposes of this subpart and section 936, in the case of any taxpayer who sustains an overall domestic loss for any taxable year beginning after December 31, 2006, that portion of the taxpayer's taxable income from sources within the United States for each succeeding taxable year which is equal to the lesser of—

"(A) the amount of such loss (to the extent not used under this paragraph in prior taxable years), or

"(B) 50 percent of the taxpayer's taxable income from sources within the United States for such succeeding taxable year,

shall be treated as income from sources without the United States (and not as income from sources within the United States).

"(2) OVERALL DOMESTIC LOSS DEFINED.—For purposes of this subsection—

"(A) IN GENERAL.—The term 'overall domestic loss' means any domestic loss to the extent such loss offsets taxable income from sources without the United States for the taxable year or for any preceding taxable year by reason of a carryback. For purposes of the preceding sentence, the term 'domestic loss' means the amount by which the gross income for the taxable year from sources within the United States is exceeded by the sum of the deductions properly apportioned or allocated thereto (determined without regard to any carryback from a subsequent taxable year).

"(B) TAXPAYER MUST HAVE ELECTED FOREIGN TAX CREDIT FOR YEAR OF LOSS.—The term 'overall domestic loss' shall not include any loss for any taxable year unless the taxpayer chose the benefits of this subpart for such taxable year.

"(3) CHARACTERIZATION OF SUBSEQUENT INCOME.—

"(A) IN GENERAL.—Any income from sources within the United States that is treated as income from sources without the United States under paragraph (1) shall be allocated among and increase the income categories in proportion to the loss from sources within the United States previously allocated to those income categories.

"(B) INCOME CATEGORY.—For purposes of this paragraph, the term 'income category' has the meaning given such term by subsection (f)(5)(E)(i).

"(4) COORDINATION WITH SUBSECTION (f).—The Secretary shall prescribe such regulations as may be necessary to coordinate the provisions of this subsection with the provisions of subsection (f).".

(b) CONFORMING AMENDMENTS.—

(1) Section 535(d)(2) is amended by striking "section 904(g)(6)" and inserting "section 904(h)(6)".

(2) Subparagraph (A) of section 936(a)(2) is amended by striking "section 904(f)" and inserting "subsections (f) and (g) of section 904".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to losses for taxable years beginning after December 31, 2006.

**SEC. 303. REDUCTION TO 2 FOREIGN TAX CREDIT BASKETS.**

(a) IN GENERAL.—Paragraph (1) of section 904(d) (relating to separate application of section with respect to certain categories of income) is amended to read as follows:

"(1) IN GENERAL.—The provisions of subsections (a), (b), and (c) and sections 902, 907, and 960 shall be applied separately with respect to—

"(A) passive category income, and

"(B) general category income."

(b) CATEGORIES.—Paragraph (2) of section 904(d) is amended by striking subparagraph (B), by redesignating subparagraph (A) as subparagraph (B), and by inserting before subparagraph (B) (as so redesignated) the following new subparagraph:

"(A) CATEGORIES.—

"(i) PASSIVE CATEGORY INCOME.—The term 'passive category income' means passive income and specified passive category income.

"(ii) GENERAL CATEGORY INCOME.—The term 'general category income' means income other than passive category income."

(c) SPECIFIED PASSIVE CATEGORY INCOME.—Subparagraph (B) of section 904(d)(2), as so redesignated, is amended by adding at the end the following new clause:

"(v) SPECIFIED PASSIVE CATEGORY INCOME.—The term 'specified passive category income' means—

"(I) dividends from a DISC or former DISC (as defined in section 992(a)) to the extent such dividends are treated as income from sources without the United States,

"(II) taxable income attributable to foreign trade income (within the meaning of section 923(b)), and

"(III) distributions from a FSC (or a former FSC) out of earnings and profits attributable to foreign trade income (within the meaning of section 923(b)) or interest or carrying charges (as defined in section 927(d)(1)) derived from a transaction which results in foreign trade income (as defined in section 923(b))."

(d) TREATMENT OF FINANCIAL SERVICES.—Paragraph (2) of section 904(d) is amended by striking subparagraph (D), by redesignating subparagraph (C) as subparagraph (D), and by inserting before subparagraph (D) (as so redesignated) the following new subparagraph:

"(C) TREATMENT OF FINANCIAL SERVICES INCOME AND COMPANIES.—

"(i) IN GENERAL.—Financial services income shall be treated as general category income in the case of—

"(I) a member of a financial services group, and

"(II) any other person if such person is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business.

"(ii) FINANCIAL SERVICES GROUP.—The term 'financial services group' means any affiliated group (as defined in section 1504(a) without regard to paragraphs (2) and (3) of section 1504(b)) which is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business. In determining whether such a group is so engaged, there shall be taken into account only the income of members of the group that are—

"(I) United States corporations, or

"(II) controlled foreign corporations in which such United States corporations own, directly or indirectly, at least 80 percent of the total voting power and value of the stock.

"(iii) PASS-THRU ENTITIES.—The Secretary shall by regulation specify for purposes of this subparagraph the treatment of financial services income received or accrued by partnerships and by other pass-thru entities which are not members of a financial services group."

(e) CONFORMING AMENDMENTS.—

(1) Clause (iii) of section 904(d)(2)(B) (relating to exceptions from passive income), as so redesignated, is amended by striking subclause (I) and by redesignating subclauses (II) and (III) as subclauses (I) and (II), respectively.

(2) Clause (i) of section 904(d)(2)(D) (defining financial services income), as so redesignated, is amended by adding "or" at the end of subclause (I) and by striking subclauses (II) and (III) and inserting the following new subclause:

"(II) passive income (determined without regard to subparagraph (B)(iii)(II))."

(3) Section 904(d)(2)(D) (defining financial services income), as so redesignated, is amended by striking clause (iii).

(4) Paragraph (3) of section 904(d) is amended to read as follows:

"(3) LOOK-THRU IN CASE OF CONTROLLED FOREIGN CORPORATIONS.—

"(A) IN GENERAL.—Except as otherwise provided in this paragraph, dividends, interest, rents, and royalties received or accrued by the taxpayer from a controlled foreign corporation in which the taxpayer is a United States shareholder shall not be treated as passive category income.

"(B) SUBPART F INCLUSIONS.—Any amount included in gross income under section 951(a)(1)(A) shall be treated as passive category income to the extent the amount so included is attributable to passive category income.

"(C) INTEREST, RENTS, AND ROYALTIES.—Any interest, rent, or royalty which is received or accrued from a controlled foreign corporation in which the taxpayer is a United States shareholder shall be treated as passive category income to the extent it is properly allocable (under regulations prescribed by the Secretary) to passive category income of the controlled foreign corporation.

"(D) DIVIDENDS.—Any dividend paid out of the earnings and profits of any controlled foreign corporation in which the taxpayer is a United States shareholder shall be treated as passive category income in proportion to the ratio of—

"(i) the portion of the earnings and profits attributable to passive category income, to

"(ii) the total amount of earnings and profits.

"(E) LOOK-THRU APPLIES ONLY WHERE SUBPART F APPLIES.—If a controlled foreign corporation meets the requirements of section 954(b)(3)(A) (relating to de minimis rule) for any taxable year, for purposes of this paragraph, none of its foreign base company income (as defined in section 954(a) without regard to section 954(b)(5)) and none of its gross insurance income (as defined in section 954(b)(3)(C)) for such taxable year shall be treated as passive category income, except that this sentence shall not apply to any income which (without regard to this sentence) would be treated as financial services income. Solely for purposes of applying subparagraph (D), passive income of a controlled foreign corporation shall not be treated as passive category income if the requirements of section 954(b)(4) are met with respect to such income.

"(F) COORDINATION WITH HIGH-TAXED INCOME PROVISIONS.—

"(i) In determining whether any income of a controlled foreign corporation is passive category income, subclause (II) of paragraph (2)(B)(iii) shall not apply.

"(ii) Any income of the taxpayer which is treated as passive category income under this paragraph shall be so treated notwithstanding any provision of paragraph (2); except that the determination of whether any amount is high-taxed income shall be made after the application of this paragraph.

"(G) DIVIDEND.—For purposes of this paragraph, the term 'dividend' includes any amount included in gross income in section 951(a)(1)(B). Any amount included in gross income under section 78 to the extent attributable to amounts included in gross income in section 951(a)(1)(A) shall not be treated as a dividend but shall be treated as included in gross income under section 951(a)(1)(A).

"(H) LOOK-THRU APPLIES TO PASSIVE FOREIGN INVESTMENT COMPANY INCLUSION.—If—

"(i) a passive foreign investment company is a controlled foreign corporation, and

"(ii) the taxpayer is a United States shareholder in such controlled foreign corporation,

any amount included in gross income under section 1293 shall be treated as income in a separate category to the extent such amount is attributable to income in such category."

(5) TREATMENT OF INCOME TAX BASE DIFFERENCES.—Paragraph (2) of section 904(d) is amended by redesignating subparagraphs (H) and (I) as subparagraphs (I) and (J), respectively, and by inserting after subparagraph (G) the following new subparagraph:

"(H) TREATMENT OF INCOME TAX BASE DIFFERENCES.—Tax imposed under the law of a foreign country or possession of the United States on an amount which does not constitute income under United States tax principles shall be treated as imposed on income described in paragraph (1)(B)."

(6) Paragraph (2) of section 904(d) is amended by adding at the end the following new subparagraph:

"(K) TRANSITIONAL RULES FOR 2007 CHANGES.—For purposes of paragraph (1)—

"(i) taxes carried from any taxable year beginning before January 1, 2007, to any taxable year beginning on or after such date, with respect to any item of income, shall be treated as described in the subparagraph of paragraph (1) in which such income would be described were such taxes paid or accrued in a taxable year beginning on or after such date, and

"(ii) the Secretary may by regulations provide for the allocation of any carryback of taxes with respect to income to such a taxable year

for purposes of allocating such income among the separate categories in effect for such taxable year.".

(7) Section 904(j)(3)(A)(i) is amended by striking "subsection (d)(2)(A)" and inserting "subsection (d)(2)(B)".

(f) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2006.

**SEC. 304. LOOK-THRU RULES TO APPLY TO DIVIDENDS FROM NONCONTROLLED SECTION 902 CORPORATIONS.**

(a) IN GENERAL.—Section 904(d)(4) (relating to look-thru rules apply to dividends from noncontrolled section 902 corporations) is amended to read as follows:

"(4) LOOK-THRU APPLIES TO DIVIDENDS FROM NONCONTROLLED SECTION 902 CORPORATIONS.—

"(A) IN GENERAL.—For purposes of this subsection, any dividend from a noncontrolled section 902 corporation with respect to the taxpayer shall be treated as income described in a subparagraph of paragraph (1) in proportion to the ratio of—

"(i) the portion of earnings and profits attributable to income described in such subparagraph, to

"(ii) the total amount of earnings and profits.

"(B) EARNINGS AND PROFITS OF CONTROLLED FOREIGN CORPORATIONS.—In the case of any distribution from a controlled foreign corporation to a United States shareholder, rules similar to the rules of subparagraph (A) shall apply in determining the extent to which earnings and profits of the controlled foreign corporation which are attributable to dividends received from a noncontrolled section 902 corporation may be treated as income in a separate category.

"(C) SPECIAL RULES.—For purposes of this paragraph—

"(i) EARNINGS AND PROFITS.—

"(I) IN GENERAL.—The rules of section 316 shall apply.

"(II) REGULATIONS.—The Secretary may prescribe regulations regarding the treatment of distributions out of earnings and profits for periods before the taxpayer's acquisition of the stock to which the distributions relate.

"(ii) INADEQUATE SUBSTANTIATION.—If the Secretary determines that the proper subparagraph of paragraph (1) in which a dividend is described has not been substantiated, such dividend shall be treated as income described in paragraph (1)(A).

"(iii) COORDINATION WITH HIGH-TAXED INCOME PROVISIONS.—Rules similar to the rules of paragraph (3)(F) shall apply for purposes of this paragraph.

"(iv) LOOK-THRU WITH RESPECT TO CARRYOVER OF CREDIT.—Rules similar to subparagraph (A) also shall apply to any carryforward under subsection (c) from a taxable year beginning before January 1, 2003, of tax allocable to a dividend from a noncontrolled section 902 corporation with respect to the taxpayer. The Secretary may by regulations provide for the allocation of any carryback of tax allocable to a dividend from a noncontrolled section 902 corporation to such a taxable year for purposes of allocating such dividend among the separate categories in effect for such taxable year.".

(b) CONFORMING AMENDMENTS.—

(1) Subparagraph (E) of section 904(d)(1) is hereby repealed.

(2) Section 904(d)(2)(C)(iii) is amended by adding "and" at the end of subclause (I), by striking subclause (II), and by redesignating subclause (III) as subclause (II).

(3) The last sentence of section 904(d)(2)(D) is amended to read as follows: "Such term does not include any financial services income.".

(4) Section 904(d)(2)(E) is amended—

(A) by inserting "or (4)" after "paragraph (3)" in clause (i), and

(B) by striking clauses (ii) and (iv) and by redesignating clause (iii) as clause (ii).

(5) Section 904(d)(3)(F) is amended by striking "(D), or (E)" and inserting "or (D)".

(6) Section 864(d)(5)(A)(i) is amended by striking "(C)(iii)(III)" and inserting "(C)(iii)(II)".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2002.

**SEC. 305. ATTRIBUTION OF STOCK OWNERSHIP THROUGH PARTNERSHIPS TO APPLY IN DETERMINING SECTION 902 AND 960 CREDITS.**

(a) IN GENERAL.—Subsection (c) of section 902 is amended by redesignating paragraph (7) as paragraph (8) and by inserting after paragraph (6) the following new paragraph:

"(7) CONSTRUCTIVE OWNERSHIP THROUGH PARTNERSHIPS.—Stock owned, directly or indirectly, by or for a partnership shall be considered as being owned proportionately by its partners. Stock considered to be owned by a person by reason of the preceding sentence shall, for purposes of applying such sentence, be treated as actually owned by such person. The Secretary may prescribe such regulations as may be necessary to carry out the purposes of this paragraph, including rules to account for special partnership allocations of dividends, credits, and other incidents of ownership of stock in determining proportionate ownership.".

(b) CLARIFICATION OF COMPARABLE ATTRIBUTION UNDER SECTION 901(b)(5).—Paragraph (5) of section 901(b) is amended by striking "any individual" and inserting "any person".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxes of foreign corporations for taxable years of such corporations beginning after the date of the enactment of this Act.

**SEC. 306. CLARIFICATION OF TREATMENT OF CERTAIN TRANSFERS OF INTANGIBLE PROPERTY.**

(a) IN GENERAL.—Subparagraph (C) of section 367(d)(2) is amended by adding at the end the following new sentence: "For purposes of applying section 904(d), any such amount shall be treated in the same manner as if such amount were a royalty.".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to amounts treated as received pursuant to section 367(d)(2) of the Internal Revenue Code of 1986 on or after August 5, 1997.

**SEC. 307. UNITED STATES PROPERTY NOT TO INCLUDE CERTAIN ASSETS OF CONTROLLED FOREIGN CORPORATION.**

(a) IN GENERAL.—Section 956(c)(2) (relating to exceptions from property treated as United States property) is amended by striking "and" at the end of subparagraph (J), by striking the period at the end of subparagraph (K) and inserting a semicolon, and by adding at the end the following new subparagraphs:

"(L) securities acquired and held by a controlled foreign corporation in the ordinary course of its business as a dealer in securities if—

"(i) the dealer accounts for the securities as securities held primarily for sale to customers in the ordinary course of business, and

"(ii) the dealer disposes of the securities (or such securities mature while held by the dealer) within a period consistent with the holding of securities for sale to customers in the ordinary course of business; and

"(M) an obligation of a United States person which—

"(i) is not a domestic corporation, and

"(ii) is not—

"(I) a United States shareholder (as defined in section 951(b)) of the controlled foreign corporation, or

"(II) a partnership, estate, or trust in which the controlled foreign corporation, or any related person (as defined in section 954(d)(3)), is a partner, beneficiary, or trustee immediately after the acquisition of any obligation of such partnership, estate, or trust by the controlled foreign corporation.".

(b) CONFORMING AMENDMENT.—Section 956(c)(2) is amended by striking "and (K)" in the last sentence and inserting ", (K), and (L)".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years of foreign corporations beginning after December 31, 2004, and to taxable years of United States shareholders with or within which such taxable years of foreign corporations end.

**SEC. 308. ELECTION NOT TO USE AVERAGE EXCHANGE RATE FOR FOREIGN TAX PAID OTHER THAN IN FUNCTIONAL CURRENCY.**

(a) IN GENERAL.—Paragraph (1) of section 986(a) (relating to determination of foreign taxes and foreign corporation's earnings and profits) is amended by redesignating subparagraph (D) as subparagraph (E) and by inserting after subparagraph (C) the following new subparagraph:

"(D) ELECTIVE EXCEPTION FOR TAXES PAID OTHER THAN IN FUNCTIONAL CURRENCY.—

"(i) IN GENERAL.—At the election of the taxpayer, subparagraph (A) shall not apply to any foreign income taxes the liability for which is denominated in any currency other than in the taxpayer's functional currency.

"(ii) APPLICATION TO QUALIFIED BUSINESS UNITS.—An election under this subparagraph may apply to foreign income taxes attributable to a qualified business unit in accordance with regulations prescribed by the Secretary.

"(iii) ELECTION.—Any such election shall apply to the taxable year for which made and all subsequent taxable years unless revoked with the consent of the Secretary.".

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2004.

**SEC. 309. REPEAL OF WITHHOLDING TAX ON DIVIDENDS FROM CERTAIN FOREIGN CORPORATIONS.**

(a) IN GENERAL.—Paragraph (2) of section 871(i) (relating to tax not to apply to certain interest and dividends) is amended by adding at the end the following new subparagraph:

"(D) Dividends paid by a foreign corporation which are treated under section 861(a)(2)(B) as income from sources within the United States.".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to payments made after December 31, 2004.

**SEC. 310. PROVIDE EQUAL TREATMENT FOR INTEREST PAID BY FOREIGN PARTNERSHIPS AND FOREIGN CORPORATIONS.**

(a) IN GENERAL.—Paragraph (1) of section 861(a) is amended by striking "and" at the end of subparagraph (A), by striking the period at the end of subparagraph (B) and inserting ", and", and by adding at the end the following new subparagraph:

"(C) in the case of a foreign partnership, which is predominantly engaged in the active conduct of a trade or business outside the United States, any interest not paid by a trade or business engaged in by the partnership in the United States and not allocable to income which is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States.".

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2003.

**SEC. 311. LOOK-THRU TREATMENT OF PAYMENTS BETWEEN RELATED CONTROLLED FOREIGN CORPORATIONS UNDER FOREIGN PERSONAL HOLDING COMPANY INCOME RULES.**

(a) IN GENERAL.—Subsection (c) of section 954, as amended by this Act, is amended by adding after paragraph (4) the following new paragraph:

"(5) LOOK-THRU IN THE CASE OF RELATED CONTROLLED FOREIGN CORPORATIONS.—For purposes of this subsection, dividends, interest, rents, and royalties received or accrued from a controlled foreign corporation which is a related person (as defined in subsection (b)(9)) shall not be treated as foreign personal holding company income to the extent attributable or properly allocable (determined under rules similar to the rules of subparagraphs (C) and (D) of section 904(d)(3)) to income of the related person which is not subpart F income (as defined in section 952). For purposes of this paragraph, interest shall include factoring income which is treated as income equivalent to interest for purposes of paragraph (1)(E). The Secretary shall prescribe such regulations as may be appropriate to prevent the abuse of the purposes of this paragraph.".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years of foreign corporations beginning after December 31, 2004, and to taxable years of United States shareholders with or within which such taxable years of foreign corporations end.

**SEC. 312. LOOK-THRU TREATMENT FOR SALES OF PARTNERSHIP INTERESTS.**

(a) IN GENERAL.—Section 954(c) (defining foreign personal holding company income), as amended by this Act, is amended by adding after paragraph (5) the following new paragraph:

"(6) LOOK-THRU RULE FOR CERTAIN PARTNERSHIP SALES.—

"(A) IN GENERAL.—In the case of any sale by a controlled foreign corporation of an interest in a partnership with respect to which such corporation is a 25-percent owner, such corporation shall be treated for purposes of this subsection as selling the proportionate share of the assets of the partnership attributable to such interest. The Secretary shall prescribe such regulations as may be appropriate to prevent abuse of the purposes of this para-

graph, including regulations providing for coordination of this paragraph with the provisions of subchapter K.

"(B) 25-PERCENT OWNER.—For purposes of this paragraph, the term '25-percent owner' means a controlled foreign corporation which owns directly 25 percent or more of the capital or profits interest in a partnership. For purposes of the preceding sentence, if a controlled foreign corporation is a shareholder or partner of a corporation or partnership, the controlled foreign corporation shall be treated as owning directly its proportionate share of any such capital or profits interest held directly or indirectly by such corporation or partnership.".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years of foreign corporations beginning after December 31, 2004, and to taxable years of United States shareholders with or within which such taxable years of foreign corporations end.

**SEC. 313. REPEAL OF FOREIGN PERSONAL HOLDING COMPANY RULES AND FOREIGN INVESTMENT COMPANY RULES.**

(a) GENERAL RULE.—The following provisions are hereby repealed:

(1) Part III of subchapter G of chapter 1 (relating to foreign personal holding companies).

(2) Section 1246 (relating to gain on foreign investment company stock).

(3) Section 1247 (relating to election by foreign investment companies to distribute income currently).

(b) EXEMPTION OF FOREIGN CORPORATIONS FROM PERSONAL HOLDING COMPANY RULES.—

(1) IN GENERAL.—Subsection (c) of section 542 (relating to exceptions) is amended—

(A) by striking paragraph (5) and inserting the following:

"(5) a foreign corporation,",

(B) by striking paragraphs (7) and (10) and by redesignating paragraphs (8) and (9) as paragraphs (7) and (8), respectively,

(C) by inserting "and" at the end of paragraph (7) (as so redesignated), and

(D) by striking "; and" at the end of paragraph (8) (as so redesignated) and inserting a period.

(2) TREATMENT OF INCOME FROM PERSONAL SERVICE CONTRACTS.—Paragraph (1) of section 954(c) is amended by adding at the end the following new subparagraph:

"(I) PERSONAL SERVICE CONTRACTS.—

"(i) Amounts received under a contract under which the corporation is to furnish personal services if—

"(I) some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or

"(II) the individual who is to perform the services is designated (by name or by description) in the contract, and

"(ii) amounts received from the sale or other disposition of such a contract.

This subparagraph shall apply with respect to amounts received for services under a particular contract only if at some time during the taxable year 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the individual who has performed, is to perform, or may be designated (by name or by description) as the one to perform, such services.".

(c) CONFORMING AMENDMENTS.—

(1) Section 1(h) is amended—

(A) in paragraph (10), by inserting "and" at the end of subparagraph (F), by striking subparagraph (G), and by redesignating subparagraph (H) as subparagraph (G), and

(B) by striking "a foreign personal holding company (as defined in section 552), a foreign investment company (as defined in section 1246(b)), or" in paragraph (11)(C)(iii).

(2) Section 163(e)(3)(B), as amended by section 642(a) of this Act, is amended by striking "which is a foreign personal holding company (as defined in section 552), a controlled foreign corporation (as defined in section 957), or" and inserting "which is a controlled foreign corporation (as defined in section 957) or".

(3) Paragraph (2) of section 171(c) is amended—

(A) by striking ", or by a foreign personal holding company, as defined in section 552", and

(B) by striking ", or foreign personal holding company".

(4) Paragraph (2) of section 245(a) is amended by striking "foreign personal holding company or".

(5) Section 267(a)(3)(B), as amended by section 642(b) of this Act, is amended by striking "to a foreign personal holding company (as defined in section 552), a controlled foreign corporation (as defined in section 957), or" and inserting "to a controlled foreign corporation (as defined in section 957) or".

(6) Section 312 is amended by striking subsection (j).

(7) Subsection (m) of section 312 is amended by striking ", a foreign investment company (within the meaning of section 1246(b)), or a foreign personal holding company (within the meaning of section 552)".

(8) Subsection (e) of section 443 is amended by striking paragraph (3) and by redesignating paragraphs (4) and (5) as paragraphs (3) and (4), respectively.

(9) Subparagraph (B) of section 465(c)(7) is amended by adding "or" at the end of clause (i), by striking clause (ii), and by redesignating clause (iii) as clause (ii).

(10) Paragraph (1) of section 543(b) is amended by inserting "and" at the end of subparagraph (A), by striking ", and" at the end of subparagraph (B) and inserting a period, and by striking subparagraph (C).

(11) Paragraph (1) of section 562(b) is amended by striking "or a foreign personal holding company described in section 552".

(12) Section 563 is amended—

(A) by striking subsection (c),

(B) by redesignating subsection (d) as subsection (c), and

(C) by striking "subsection (a), (b), or (c)" in subsection (c) (as so redesignated) and inserting "subsection (a) or (b)".

(13) Subsection (d) of section 751 is amended by adding "and" at the end of paragraph (2), by striking paragraph (3), by redesignating paragraph (4) as paragraph (3), and by striking "paragraph (1), (2), or (3)" in paragraph (3) (as so redesignated) and inserting "paragraph (1) or (2)".

(14) Paragraph (2) of section 864(d) is amended by striking subparagraph (A) and by redesignating subparagraphs (B) and (C) as subparagraphs (A) and (B), respectively.

(15)(A) Subparagraph (A) of section 898(b)(1) is amended to read as follows:

"(A) which is treated as a controlled foreign corporation for any purpose under subpart F of part III of this subchapter, and".

(B) Subparagraph (B) of section 898(b)(2) is amended by striking "and sections 551(f) and 554, whichever are applicable,".

(C) Paragraph (3) of section 898(b) is amended to read as follows:

"(3) UNITED STATES SHAREHOLDER.—The term 'United States shareholder' has the meaning given to such term by section 951(b), except that, in the case of a foreign corporation having related person insurance income (as defined in section 953(c)(2)), the Secretary may treat any person as a United States shareholder for purposes of this section if such person is treated as a United States shareholder under section 953(c)(1).".

(D) Subsection (c) of section 898 is amended to read as follows:

"(c) DETERMINATION OF REQUIRED YEAR.—

"(1) IN GENERAL.—The required year is—

"(A) the majority U.S. shareholder year, or

"(B) if there is no majority U.S. shareholder year, the taxable year prescribed under regulations.

"(2) 1-MONTH DEFERRAL ALLOWED.—A specified foreign corporation may elect, in lieu of the taxable year under paragraph (1)(A), a taxable year beginning 1 month earlier than the majority U.S. shareholder year.

"(3) MAJORITY U.S. SHAREHOLDER YEAR.—

"(A) IN GENERAL.—For purposes of this subsection, the term 'majority U.S. shareholder year' means the taxable year (if any) which, on each testing day, constituted the taxable year of—

"(i) each United States shareholder described in subsection (b)(2)(A), and

"(ii) each United States shareholder not described in clause (i) whose stock was treated as owned under subsection (b)(2)(B) by any shareholder described in such clause.

"(B) TESTING DAY.—The testing days shall be—

"(i) the first day of the corporation's taxable year (determined without regard to this section), or

"(ii) the days during such representative period as the Secretary may prescribe.".

(16) Clause (ii) of section 904(d)(2)(A) is amended to read as follows:

"(ii) CERTAIN AMOUNTS INCLUDED.—Except as provided in clause (iii), the term 'passive income' includes, except as provided in subparagraph (E)(iii) or paragraph (3)(I), any amount includible in gross income under section 1293 (relating to certain passive foreign investment companies).".

(17)(A) Subparagraph (A) of section 904(h)(1), as redesignated by section 302, is amended by adding "or" at the end of clause (i), by striking clause (ii), and by redesignating clause (iii) as clause (ii).

(B) The paragraph heading of paragraph (2) of section 904(h), as so redesignated, is amended by striking "FOREIGN PERSONAL HOLDING OR".

(18) Section 951 is amended by striking subsections (c) and (d) and by redesignating subsections (e) and (f) as subsections (c) and (d), respectively.

(19) Paragraph (3) of section 989(b) is amended by striking ", 551(a),".

(20) Paragraph (5) of section 1014(b) is amended by inserting "and before January 1, 2005," after "August 26, 1937,".

(21) Subsection (a) of section 1016 is amended by striking paragraph (13).

(22)(A) Paragraph (3) of section 1212(a) is amended to read as follows:

"(3) SPECIAL RULES ON CARRYBACKS.—A net capital loss of a corporation shall not be carried back under paragraph (1)(A) to a taxable year—

"(A) for which it is a regulated investment company (as defined in section 851), or

"(B) for which it is a real estate investment trust (as defined in section 856).".

(B) The amendment made by subparagraph (A) shall apply to taxable years beginning after December 31, 2004.

(23) Section 1223 is amended by striking paragraph (10) and by redesignating the following paragraphs accordingly.

(24) Subsection (d) of section 1248 is amended by striking paragraph (5) and by redesignating paragraphs (6) and (7) as paragraphs (5) and (6), respectively.

(25) Paragraph (2) of section 1260(c) is amended by striking subparagraphs (H) and (I) and by redesignating subparagraph (J) as subparagraph (H).

(26)(A) Subparagraph (F) of section 1291(b)(3) is amended by striking "551(d), 959(a)," and inserting "959(a)".

(B) Subsection (e) of section 1291 is amended by inserting "(as in effect on the day before the date of the enactment of the American Jobs Creation Act of 2004)" after "section 1246".

(27) Paragraph (2) of section 1294(a) is amended to read as follows:

"(2) ELECTION NOT PERMITTED WHERE AMOUNTS OTHERWISE INCLUDIBLE UNDER SECTION 951.—The taxpayer may not make an election under paragraph (1) with respect to the undistributed PFIC earnings tax liability attributable to a qualified electing fund for the taxable year if any amount is includible in the gross income of the taxpayer under section 951 with respect to such fund for such taxable year.".

(28) Section 6035 is hereby repealed.

(29) Subparagraph (D) of section 6103(e)(1) is amended by striking clause (iv) and redesignating clauses (v) and (vi) as clauses (iv) and (v), respectively.

(30) Subparagraph (B) of section 6501(e)(1) is amended to read as follows:

"(B) CONSTRUCTIVE DIVIDENDS.—If the taxpayer omits from gross income an amount properly includible therein under section 951(a), the tax may be assessed, or a proceeding in court for the collection of such tax may be done without assessing, at any time within 6 years after the return was filed.".

(31) Subsection (a) of section 6679 is amended—

(A) by striking "6035, 6046, and 6046A" in paragraph (1) and inserting "6046 and 6046A", and

(B) by striking paragraph (3).

(32) Sections 170(f)(10)(A), 508(d), 4947, and 4948(c)(4) are each amended by striking "556(b)(2)," each place it appears.

(33) The table of parts for subchapter G of chapter 1 is amended by striking the item relating to part III.

(34) The table of sections for part IV of subchapter P of chapter 1 is amended by striking the items relating to sections 1246 and 1247.

(35) The table of sections for subpart A of part III of subchapter A of chapter 61 is amended by striking the item relating to section 6035.

(d) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to taxable years of foreign corporations beginning after December 31, 2004, and to taxable years of United States shareholders with or within which such taxable years of foreign corporations end.

(2) SUBSECTION (c)(29).—The amendments made by subsection (c)(29) shall apply to disclosures of return or return information with respect to taxable years beginning after December 31, 2004.

**SEC. 314. DETERMINATION OF FOREIGN PERSONAL HOLDING COMPANY INCOME WITH RESPECT TO TRANSACTIONS IN COMMODITIES.**

(a) IN GENERAL.—Clauses (i) and (ii) of section 954(c)(1)(C) (relating to commodity transactions) are amended to read as follows:

"(i) arise out of commodity hedging transactions (as defined in paragraph (4)(A)),

"(ii) are active business gains or losses from the sale of commodities, but only if substantially all of the controlled foreign corporation's commodities are property described in paragraph (1), (2), or (8) of section 1221(a), or".

(b) DEFINITION AND SPECIAL RULES.—Subsection (c) of section 954 is amended by adding after paragraph (3) the following new paragraph:

"(4) DEFINITION AND SPECIAL RULES RELATING TO COMMODITY TRANSACTIONS.—

"(A) COMMODITY HEDGING TRANSACTIONS.—For purposes of paragraph (1)(C)(i), the term 'commodity hedging transaction' means any transaction with respect to a commodity if such transaction—

"(i) is a hedging transaction as defined in section 1221(b)(2), determined—

"(I) without regard to subparagraph (A)(ii) thereof,

"(II) by applying subparagraph (A)(i) thereof by substituting 'ordinary property or property described in section 1231(b)' for 'ordinary property', and

"(III) by substituting 'controlled foreign corporation' for 'taxpayer' each place it appears, and

"(ii) is clearly identified as such in accordance with section 1221(a)(7).

"(B) TREATMENT OF DEALER ACTIVITIES UNDER PARAGRAPH (1)(C).—Commodities with respect to which gains and losses are not taken into account under paragraph (2)(C) in computing a controlled foreign corporation's foreign personal holding company income shall not be taken into account in applying the substantially all test under paragraph (1)(C)(ii) to such corporation.

"(C) REGULATIONS.—The Secretary shall prescribe such regulations as are appropriate to carry out the purposes of paragraph (1)(C) in the case of transactions involving related parties.".

(c) MODIFICATION OF EXCEPTION FOR DEALERS.—Clause (i) of section 954(c)(2)(C) is amended by inserting "and transactions involving physical settlement" after "(including hedging transactions".

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to transactions entered into after December 31, 2004.

**SEC. 315. MODIFICATIONS TO TREATMENT OF AIRCRAFT LEASING AND SHIPPING INCOME.**

(a) ELIMINATION OF FOREIGN BASE COMPANY SHIPPING INCOME.—Section 954 (relating to foreign base company income) is amended—

(1) by striking paragraph (4) of subsection (a) (relating to foreign base company shipping income), and

(2) by striking subsection (f) (relating to foreign base company shipping income).

(b) SAFE HARBOR FOR CERTAIN LEASING ACTIVITIES.—Subparagraph (A) of section 954(c)(2) is amended by adding at the end the following new sentence: "For purposes of the preceding sentence, rents derived from leasing an aircraft or vessel in foreign commerce shall not fail to be treated as derived in the active conduct of a trade or business if, as determined under regulations prescribed by the Secretary, the active leasing expenses are not less than 10 percent of the profit on the lease."

(c) CONFORMING AMENDMENTS.—

(1) Section 952(c)(1)(B)(iii) is amended by striking subclause (I) and redesignating subclauses (II) through (VI) as subclauses (I) through (V), respectively.

(2) Subsection (b) of section 954 is amended—

(A) by striking "the foreign base company shipping income," in paragraph (5),

(B) by striking paragraphs (6) and (7), and

(C) by redesignating paragraph (8) as paragraph (6).

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years of foreign corporations beginning after December 31, 2004, and to taxable years of United States shareholders with or within which such taxable years of foreign corporations end.

**SEC. 316. MODIFICATION OF EXCEPTIONS UNDER SUBPART F FOR ACTIVE FINANCING.**

(a) IN GENERAL.—Section 954(h)(3) is amended by adding at the end the following:

"(E) DIRECT CONDUCT OF ACTIVITIES.—For purposes of subparagraph (A)(ii)(II), an activity shall be treated as conducted directly by an eligible controlled foreign corporation or qualified business unit in its home country if the activity is performed by employees of a related person and—

"(i) the related person is an eligible controlled foreign corporation the home country of which is the same as the home country of the corporation or unit to which subparagraph (A)(ii)(II) is being applied,

"(ii) the activity is performed in the home country of the related person, and

"(iii) the related person is compensated on an arm's-length basis for the performance of the activity by its employees and such compensation is treated as earned by such person in its home country for purposes of the home country's tax laws.".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years of such foreign corporations beginning after December 31, 2004, and to taxable years of United States shareholders with or within which such taxable years of such foreign corporations end.

# TITLE IV—EXTENSION OF CERTAIN EXPIRING PROVISIONS

**SEC. 401. ALLOWANCE OF NONREFUNDABLE PERSONAL CREDITS AGAINST REGULAR AND MINIMUM TAX LIABILITY.**

(a) IN GENERAL.—Paragraph (2) of section 26(a) is amended—

(1) by striking "RULE FOR 2000, 2001, 2002, AND 2003.—" and inserting "RULE FOR TAXABLE YEARS 2000 THROUGH 2005.—", and

(2) by striking "or 2003," and inserting "2003, 2004, or 2005,".

(b) CONFORMING PROVISIONS.—

(1) Section 904(h) is amended by striking "or 2003" and inserting "2003, 2004, or 2005".

(2) The amendments made by sections 201(b), 202(f), and 618(b) of the Economic Growth and Tax Relief Reconciliation Act of 2001 shall not apply to taxable years beginning during 2004 or 2005.

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2003.

**SEC. 402. EXTENSION OF RESEARCH CREDIT.**

(a) EXTENSION.—

(1) IN GENERAL.—Section 41(h)(1)(B) (relating to termination) is amended by striking "June 30, 2004" and inserting "December 31, 2005".

(2) CONFORMING AMENDMENT.—Section 45C(b)(1)(D) is amended by striking "June 30, 2004" and inserting "December 31, 2005".

(b) EFFECTIVE DATE.—The amendments made by subsection (a) shall apply to amounts paid or incurred after June 30, 2004.

**SEC. 403. EXTENSION OF CREDIT FOR ELECTRICITY PRODUCED FROM CERTAIN RENEWABLE RESOURCES.**

(a) IN GENERAL.—Subparagraphs (A) and (B) of section 45(c)(3) (defining qualified facility) are both amended by striking "2004" and inserting "2006".

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to facilities placed in service after December 31, 2003.

**SEC. 404. INDIAN EMPLOYMENT TAX CREDIT.**

Section 45A(f) (relating to termination) is amended by striking "December 31, 2004" and inserting "December 31, 2005".

**SEC. 405. WORK OPPORTUNITY CREDIT.**

(a) IN GENERAL.—Subparagraph (B) of section 51(c)(4) is amended by striking "December 31, 2003" and inserting "December 31, 2005".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to individuals who begin work for the employer after December 31, 2003.

**SEC. 406. WELFARE-TO-WORK CREDIT.**

(a) IN GENERAL.—Subsection (f) of section 51A is amended by striking "December 31, 2003" and inserting "December 31, 2005".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to individuals who begin work for the employer after December 31, 2003.

**SEC. 407. CERTAIN EXPENSES OF ELEMENTARY AND SECONDARY SCHOOL TEACHERS.**

(a) IN GENERAL.—Subparagraph (D) of section 62(a)(2) (relating to certain trade and business deductions of employees) is amended by striking "or 2003" and inserting ", 2003, 2004, or 2005".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 2003.

**SEC. 408. EXTENSION OF ACCELERATED DEPRECIATION BENEFIT FOR PROPERTY ON INDIAN RESERVATIONS.**

Paragraph (8) of section 168(j) (relating to termination) is amended by striking "December 31, 2004" and inserting "December 31, 2005".

**SEC. 409. CHARITABLE CONTRIBUTIONS OF COMPUTER TECHNOLOGY AND EQUIPMENT USED FOR EDUCATIONAL PURPOSES.**

(a) IN GENERAL.—Subparagraph (G) of section 170(e)(6) (relating to special rule for contributions of computer technology and equipment for educational purposes) is amended by striking "December 31, 2003" and inserting "December 31, 2005".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 2003.

**SEC. 410. EXPENSING OF ENVIRONMENTAL REMEDIATION COSTS.**

(a) IN GENERAL.—Subsection (h) of section 198 (relating to termination) is amended by striking "December 31, 2003" and inserting "December 31, 2005".

(b) EFFECTIVE DATE.—The amendments made by subsection (a) shall apply to expenditures paid or incurred after December 31, 2003.

**SEC. 411. AVAILABILITY OF MEDICAL SAVINGS ACCOUNTS.**

(a) IN GENERAL.—Paragraphs (2) and (3)(B) of section 220(i) (defining cut-off year) are each amended by striking "2003" each place it appears in the text and headings and inserting "2005".

(b) CONFORMING AMENDMENTS.—

(1) Paragraph (2) of section 220(j) is amended—

(A) in the text by striking "or 2002" each place it appears and inserting "2002, or 2004", and

(B) in the heading by striking "OR 2002" and inserting "2002, OR 2004".

(2) Subparagraph (A) of section 220(j)(4) is amended by striking "and 2002" and inserting "2002, and 2004".

(3) Subparagraph (C) of section 220(j)(2) is amended to read as follows:

"(C) NO LIMITATION FOR 2000 OR 2003.—The numerical limitation shall not apply for 2000 or 2003.".

(c) EFFECTIVE DATE.—The amendments made by this section shall take effect on January 1, 2004.

(d) TIME FOR FILING REPORTS, ETC.—

(1) The report required by section 220(j)(4) of the Internal Revenue Code of 1986 to be made on August 1, 2004, shall be treated as timely if made before the close of the 90-day period beginning on the date of the enactment of this Act.

(2) The determination and publication required by section 220(j)(5) of such Code with respect to calendar year 2004 shall be treated as timely if made before the close of the 120-day period beginning on the date of the enactment of this Act. If the determination under the preceding sentence is that 2004 is a cut-off year under section 220(i) of such Code, the cut-off date under such section 220(i) shall be the last day of such 120-day period.

**SEC. 412. TAXABLE INCOME LIMIT ON PERCENTAGE DEPLETION FOR OIL AND NATURAL GAS PRODUCED FROM MARGINAL PROPERTIES.**

(a) IN GENERAL.—Subparagraph (H) of section 613A(c)(6) is amended by striking "January 1, 2004" and inserting "January 1, 2006".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 2003.

**SEC. 413. QUALIFIED ZONE ACADEMY BONDS.**

(a) IN GENERAL.—Paragraph (1) of section 1397E(e) is amended by striking "and 2003" and inserting "2003, 2004, and 2005".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to obligations issued after the date of the enactment of this Act.

**SEC. 414. DISTRICT OF COLUMBIA.**

(a) DISTRICT OF COLUMBIA ENTERPRISE ZONE.—Subsection (f) of section 1400 is amended by striking "December 31, 2003" both places it appears and inserting "December 31, 2005".

(b) TAX-EXEMPT ECONOMIC DEVELOPMENT BONDS.—Subsection (b) of section 1400A is amended by striking "December 31, 2003" and inserting "December 31, 2005".

(c) ZERO PERCENT CAPITAL GAINS RATE.—

(1) Section 1400B is amended by striking "January 1, 2004" each place it appears and inserting "January 1, 2006".

(2) Subsections (e)(2) and (g)(2) of section 1400B are each amended by striking "2008" each place it appears in the headings and text and inserting "2010".

(3) Subsection (d) of section 1400F is amended by striking "December 31, 2008" and inserting "December 31, 2010".

(d) FIRST-TIME HOMEBUYER CREDIT.—Subsection (i) of section 1400C is amended by striking "January 1, 2004" and inserting "January 1, 2006".

(e) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall take effect on the date of the enactment of this Act.

(2) TAX-EXEMPT ECONOMIC DEVELOPMENT BONDS.—The amendment made by subsection (b) shall apply to obligations issued after December 31, 2003.

**SEC. 415. EXTENSION OF CERTAIN NEW YORK LIBERTY ZONE BOND FINANCING.**

Subparagraph (D) of section 1400L(d)(2) is amended by striking "2005" and inserting "2010".

**SEC. 416. DISCLOSURES RELATING TO TERRORIST ACTIVITIES.**

(a) IN GENERAL.—Clause (iv) of section 6103(i)(3)(C) and subparagraph (E) of section 6103(i)(7) are both amended by striking "December 31, 2003" and inserting "December 31, 2005".

(b) DISCLOSURE OF TAXPAYER IDENTITY TO LAW ENFORCEMENT AGENCIES INVESTIGATING TERRORISM.—Subparagraph (A) of section 6103(i)(7) is amended by adding at the end the following new clause:

"(v) TAXPAYER IDENTITY.—For purposes of this subparagraph, a taxpayer's identity shall not be treated as taxpayer return information.".

(c) EFFECTIVE DATES.—

(1) IN GENERAL.—The amendments made by subsection (a) shall apply to disclosures on or after the date of the enactment of this Act.

(2) SUBSECTION (b).—The amendment made by subsection (b) shall take effect as if included in section 201 of the Victims of Terrorism Tax Relief Act of 2001.

**SEC. 417. DISCLOSURE OF RETURN INFORMATION RELATING TO STUDENT LOANS.**

Section 6103(l)(13)(D) (relating to termination) is amended by striking "December 31, 2004" and inserting "December 31, 2005".

**SEC. 418. COVER OVER OF TAX ON DISTILLED SPIRITS.**

(a) IN GENERAL.—Paragraph (1) of section 7652(f) is amended by striking "January 1, 2004" and inserting "January 1, 2006".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to articles brought into the United States after December 31, 2003.

**SEC. 419. JOINT REVIEW OF STRATEGIC PLANS AND BUDGET FOR THE INTERNAL REVENUE SERVICE.**

(a) IN GENERAL.—Paragraph (2) of section 8021(f) (relating to joint reviews) is amended by striking "2004" and inserting "2005".

(b) REPORT.—Subparagraph (C) of section 8022(3) (regarding reports) is amended—

(1) by striking "2004" and inserting "2005", and

(2) by striking "with respect to—" and all that follows and inserting "with respect to the matters addressed in the joint review referred to in section 8021(f)(2).".

(c) TIME FOR JOINT REVIEW.—The joint review required by section 8021(f)(2) of the Internal Revenue Code of 1986 to be made before June 1, 2004, shall be treated as timely if made before June 1, 2005.

**SEC. 420. PARITY IN THE APPLICATION OF CERTAIN LIMITS TO MENTAL HEALTH BENEFITS.**

(a) IN GENERAL.—Subsection (f) of section 9812 is amended by striking "and" at the end of paragraph (1), by striking paragraph (2), and by inserting after paragraph (1) the following new paragraphs:

"(2) on or after January 1, 2004, and before the date of the enactment of American Jobs Creation Act of 2004, and

"(3) after December 31, 2005.".

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to benefits for services furnished on or after December 31, 2003.

**SEC. 421. COMBINED EMPLOYMENT TAX REPORTING PROJECT.**

(a) IN GENERAL.—Paragraph (1) of section 976(b) of the Taxpayer Relief Act of 1997 (111 Stat. 898) is amended by striking "for a period ending with the date which is 5 years after the date of the enactment of this Act" and inserting "during the period ending on December 31, 2005".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to disclosures on or after the date of the enactment of this Act.

**SEC. 422. CLEAN-FUEL VEHICLES.**

(a) CREDIT FOR QUALIFIED ELECTRIC VEHICLES.—Paragraph (2) of section 30(b) (relating to phaseout) is amended to read as follows:

"(2) PHASEOUT.—In the case of any qualified electric vehicle placed in service after December 31, 2005, the credit otherwise allowable under subsection (a) (determined after the application of paragraph (1)) shall be reduced by 75 percent.".

(b) DEDUCTION FOR QUALIFIED CLEAN-FUEL VEHICLE PROPERTY.—Subparagraph (B) of section 179A(b)(1) (relating to phaseout) is amended to read as follows:

"(B) PHASEOUT.—In the case of any qualified clean-fuel vehicle property placed in service after December 31, 2005, the limit otherwise applicable under subparagraph (A) shall be reduced by 75 percent.".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to property placed in service after December 31, 2003.

# TITLE V—DEDUCTION OF STATE AND LOCAL GENERAL SALES TAXES

**SEC. 501. DEDUCTION OF STATE AND LOCAL GENERAL SALES TAXES IN LIEU OF STATE AND LOCAL INCOME TAXES.**

(a) IN GENERAL.—Subsection (b) of section 164 (relating to definitions and special rules) is amended by adding at the end the following:

"(5) GENERAL SALES TAXES.—For purposes of subsection (a)—

"(A) ELECTION TO DEDUCT STATE AND LOCAL SALES TAXES IN LIEU OF STATE AND LOCAL INCOME TAXES.—

"(i) IN GENERAL.—At the election of the taxpayer for the taxable year, subsection (a) shall be applied—

"(I) without regard to the reference to State and local income taxes, and

"(II) as if State and local general sales taxes were referred to in a paragraph thereof.

"(B) DEFINITION OF GENERAL SALES TAX.—The term 'general sales tax' means a tax imposed at one rate with respect to the sale at retail of a broad range of classes of items.

"(C) SPECIAL RULES FOR FOOD, ETC.—In the case of items of food, clothing, medical supplies, and motor vehicles—

"(i) the fact that the tax does not apply with respect to some or all of such items shall not be taken into account in determining whether the tax applies with respect to a broad range of classes of items, and

"(ii) the fact that the rate of tax applicable with respect to some or all of such items is lower than the general rate of tax shall not be taken into account in determining whether the tax is imposed at one rate.

"(D) ITEMS TAXED AT DIFFERENT RATES.—Except in the case of a lower rate of tax applicable with respect to an item described in subparagraph (C), no deduction shall be allowed under this paragraph for any general sales tax imposed with respect to an item at a rate other than the general rate of tax.

"(E) COMPENSATING USE TAXES.—A compensating use tax with respect to an item shall be treated as a general sales tax. For purposes of the preceding sentence, the term 'compensating use tax' means, with respect to any item, a tax which—

"(i) is imposed on the use, storage, or consumption of such item, and

"(ii) is complementary to a general sales tax, but only if a deduction is allowable under this paragraph with respect to items sold at retail in the taxing jurisdiction which are similar to such item.

"(F) SPECIAL RULE FOR MOTOR VEHICLES.—In the case of motor vehicles, if the rate of tax exceeds the general rate, such excess shall be disregarded and the general rate shall be treated as the rate of tax.

"(G) SEPARATELY STATED GENERAL SALES TAXES.—If the amount of any general sales tax is separately stated, then, to the extent that the amount so stated is paid by the consumer (other than in connection with the consumer's trade or business) to the seller, such amount shall be treated as a tax imposed on, and paid by, such consumer.

"(H) AMOUNT OF DEDUCTION TO BE DETERMINED UNDER TABLES.—

"(i) IN GENERAL.—The amount of the deduction allowed under this paragraph shall be determined under tables prescribed by the Secretary.

"(ii) REQUIREMENTS FOR TABLES.—The tables prescribed under clause (i)—

"(I) shall reflect the provisions of this paragraph,

"(II) shall be based on the average consumption by taxpayers on a State-by-State basis, as determined by the Secretary, taking into account filing status, number of dependents, adjusted gross income, and rates of State and local general sales taxation, and

"(III) need only be determined with respect to adjusted gross incomes up to the applicable amount (as determined under section 68(b)).

"(I) APPLICATION OF PARAGRAPH.—This paragraph shall apply to taxable years beginning after December 31, 2003, and before January 1, 2006.".

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2003.

# TITLE VI—REVENUE PROVISIONS

## Subtitle A—Provisions to Reduce Tax Avoidance Through Individual and Corporate Expatriation

**SEC. 601. TAX TREATMENT OF EXPATRIATED ENTITIES AND THEIR FOREIGN PARENTS.**

(a) IN GENERAL.—Subchapter C of chapter 80 (relating to provisions affecting more than one subtitle) is amended by adding at the end the following new section:

**"SEC. 7874. RULES RELATING TO EXPATRIATED ENTITIES AND THEIR FOREIGN PARENTS.**

"(a) TAX ON INVERSION GAIN OF EXPATRIATED ENTITIES.—

"(1) IN GENERAL.—The taxable income of an expatriated entity for any taxable year which includes any portion of the applicable period shall in no event be less than the inversion gain of the entity for the taxable year.

"(2) EXPATRIATED ENTITY.—For purposes of this subsection—

"(A) IN GENERAL.—The term 'expatriated entity' means—

"(i) the domestic corporation or partnership referred to in subparagraph (B)(i) with respect to which a foreign corporation is a surrogate foreign corporation, and

"(ii) any United States person who is related (within the meaning of section 267(b) or 707(b)(1)) to a domestic corporation or partnership described in clause (i).

"(B) SURROGATE FOREIGN CORPORATION.—A foreign corporation shall be treated as a surrogate foreign corporation if, pursuant to a plan (or a series of related transactions)—

"(i) the entity completes after March 4, 2003, the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation or substantially all of the properties constituting a trade or business of a domestic partnership,

"(ii) after the acquisition at least 60 percent of the stock (by vote or value) of the entity is held—

"(I) in the case of an acquisition with respect to a domestic corporation, by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation, or

"(II) in the case of an acquisition with respect to a domestic partnership, by former partners of the domestic partnership by reason of holding a capital or profits interest in the domestic partnership, and

"(iii) after the acquisition the expanded affiliated group which includes the entity does not have substantial business activities in the foreign country in which, or under the law of which, the entity is created or organized, when compared to the total business activities of such expanded affiliated group.

An entity otherwise described in clause (i) with respect to any domestic corporation or partnership trade or business shall be treated as not so described if, on or before March 4, 2003, such entity acquired directly or indirectly more than half of the properties held directly or indirectly by such corporation or more than half of the properties constituting such partnership trade or business, as the case may be.

"(b) DEFINITIONS AND SPECIAL RULES.—

"(1) EXPANDED AFFILIATED GROUP.—The term 'expanded affiliated group' means an affiliated group as defined in section 1504(a) but without regard to section 1504(b)(3), except that section 1504(a) shall be applied by substituting 'more than 50 percent' for 'at least 80 percent' each place it appears.

"(2) CERTAIN STOCK DISREGARDED.—There shall not be taken into account in determining ownership under subsection (a)(2)(B)(ii)—

"(A) stock held by members of the expanded affiliated group which includes the foreign corporation, or

"(B) stock of such foreign corporation which is sold in a public offering related to the acquisition described in subsection (a)(2)(B)(i).

"(3) PLAN DEEMED IN CERTAIN CASES.—If a foreign corporation acquires directly or indirectly substantially all of the properties of a domestic corporation or partnership during the 4-year period beginning on the date which is 2 years before the ownership requirements of subsection (a)(2)(B)(ii) are met, such actions shall be treated as pursuant to a plan.

"(4) CERTAIN TRANSFERS DISREGARDED.—The transfer of properties or liabilities (including by contribution or distribution) shall be disregarded if such transfers are part of a plan a principal purpose of which is to avoid the purposes of this section.

"(5) SPECIAL RULE FOR RELATED PARTNERSHIPS.—For purposes of applying subsection (a)(2)(B)(ii) to the acquisition of a trade or business of a domestic partnership, except as provided in regulations, all partnerships which are under common control (within the meaning of section 482) shall be treated as 1 partnership.

"(6) REGULATIONS.—The Secretary shall prescribe such regulations as may be appropriate to determine whether a corporation is a surrogate foreign corporation, including regulations—

"(A) to treat warrants, options, contracts to acquire stock, convertible debt interests, and other similar interests as stock, and

"(B) to treat stock as not stock.

"(c) OTHER DEFINITIONS.—For purposes of this section—

"(1) APPLICABLE PERIOD.—The term 'applicable period' means the period—

"(A) beginning on the first date properties are acquired as part of the acquisition described in subsection (a)(2)(B)(i), and

"(B) ending on the date which is 10 years after the last date properties are acquired as part of such acquisition.

"(2) INVERSION GAIN.—The term 'inversion gain' means the income or gain recognized by reason of the transfer during the applicable period of stock or other properties by an expatriated entity, and any income received or accrued during the applicable period by reason of a license of any property by an expatriated entity—

"(A) as part of the acquisition described in subsection (a)(2)(B)(i), or

"(B) after such acquisition if the transfer or license is to a foreign related person.

Subparagraph (B) shall not apply to property described in section 1221(a)(1) in the hands of the expatriated entity.

"(3) FOREIGN RELATED PERSON.—The term 'foreign related person' means, with respect to any expatriated entity, a foreign person which—

"(A) is related (within the meaning of section 267(b) or 707(b)(1)) to such entity, or

"(B) is under the same common control (within the meaning of section 482) as such entity.

"(d) SPECIAL RULES.—

"(1) CREDITS NOT ALLOWED AGAINST TAX ON INVERSION GAIN.—Credits (other than the credit allowed by section 901) shall be allowed against the tax imposed by this chapter on an expatriated entity for any taxable year described in subsection (a) only to the extent such tax exceeds the product of—

"(A) the amount of the inversion gain for the taxable year, and

"(B) the highest rate of tax specified in section 11(b)(1).

For purposes of determining the credit allowed by section 901, inversion gain shall be treated as from sources within the United States.

"(2) SPECIAL RULES FOR PARTNERSHIPS.—In the case of an expatriated entity which is a partnership—

"(A) subsection (a)(1) shall apply at the partner rather than the partnership level,

"(B) the inversion gain of any partner for any taxable year shall be equal to the sum of—

"(i) the partner's distributive share of inversion gain of the partnership for such taxable year, plus

"(ii) gain recognized for the taxable year by the partner by reason of the transfer during the applicable period of any partnership interest of the partner in such partnership to the surrogate foreign corporation, and

"(C) the highest rate of tax specified in the rate schedule applicable to the partner under this chapter shall be substituted for the rate of tax referred to in paragraph (1).

"(3) COORDINATION WITH SECTION 172 AND MINIMUM TAX.—Rules similar to the rules of paragraphs (3) and (4) of section 860E(a) shall apply for purposes of subsection (a).

"(4) STATUTE OF LIMITATIONS.—

"(A) IN GENERAL.—The statutory period for the assessment of any deficiency attributable to the inversion gain of any taxpayer for any pre-inversion year shall not expire before the expiration of 3 years from the date the Secretary is notified by the taxpayer (in such manner as the Secretary may prescribe) of the acquisition described in subsection (a)(2)(B)(i) to which such gain relates and such deficiency may be assessed before the expiration of such 3-year period notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment.

"(B) PRE-INVERSION YEAR.—For purposes of subparagraph (A), the term 'pre-inversion year' means any taxable year if—

"(i) any portion of the applicable period is included in such taxable year, and

"(ii) such year ends before the taxable year in which the acquisition described in subsection (a)(2)(B)(i) is completed.

"(e) SPECIAL RULE FOR TREATIES.—Nothing in section 894 or 7852(d) or in any other provision of law shall be construed as permitting an exemption, by reason of any treaty obligation of the United States heretofore or hereafter entered into, from the provisions of this section.

"(f) REGULATIONS.—The Secretary shall provide such regulations as are necessary to carry out this section, including regulations providing for such adjustments to the application of this section as are necessary to prevent the avoidance of the purposes of this section, including the avoidance of such purposes through—

"(1) the use of related persons, pass-through or other noncorporate entities, or other intermediaries, or

"(2) transactions designed to have persons cease to be (or not become) members of expanded affiliated groups or related persons.".

(b) CONFORMING AMENDMENT.—The table of sections for subchapter C of chapter 80 is amended by adding at the end the following new item:

"Sec. 7874. Rules relating to expatriated entities and their foreign parents."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years ending after March 4, 2003.

**SEC. 602. EXCISE TAX ON STOCK COMPENSATION OF INSIDERS IN EXPATRIATED CORPORATIONS.**

(a) IN GENERAL.—Subtitle D is amended by inserting after chapter 44 end the following new chapter:

## "CHAPTER 45—PROVISIONS RELATING TO EXPATRIATED ENTITIES

"Sec. 4985. Stock compensation of insiders in expatriated corporations.

**"SEC. 4985. STOCK COMPENSATION OF INSIDERS IN EXPATRIATED CORPORATIONS.**

"(a) IMPOSITION OF TAX.—In the case of an individual who is a disqualified individual with respect to any expatriated corporation, there is hereby imposed on such person a tax equal to 15 percent of the value (determined under subsection (b)) of the specified stock compensation held (directly or indirectly) by or for the benefit of such individual or a member of such individual's family (as defined in section 267) at any time during the 12-month period beginning on the date which is 6 months before the expatriation date.

"(b) VALUE.—For purposes of subsection (a)—

"(1) IN GENERAL.—The value of specified stock compensation shall be—

"(A) in the case of a stock option (or other similar right) or a stock appreciation right, the fair value of such option or right, and

"(B) in any other case, the fair market value of such compensation.

"(2) DATE FOR DETERMINING VALUE.—The determination of value shall be made—

"(A) in the case of specified stock compensation held on the expatriation date, on such date,

"(B) in the case of such compensation which is canceled during the 6 months before the expatriation date, on the day before such cancellation, and

"(C) in the case of such compensation which is granted after the expatriation date, on the date such compensation is granted.

"(c) TAX TO APPLY ONLY IF SHAREHOLDER GAIN RECOGNIZED.—Subsection (a) shall apply to any disqualified individual with respect to an expatriated corporation only if gain (if any) on any stock in such corporation is recognized in whole or part by any shareholder by reason of the acquisition referred to in section 7874(a)(2)(B)(i) with respect to such corporation.

"(d) EXCEPTION WHERE GAIN RECOGNIZED ON COMPENSATION.—Subsection (a) shall not apply to—

"(1) any stock option which is exercised on the expatriation date or during the 6-month period before such date and to the stock acquired in such exercise, if income is recognized under section 83 on or before the expatriation date with respect to the stock acquired pursuant to such exercise, and

"(2) any other specified stock compensation which is exercised, sold, exchanged, distributed, cashed-out, or otherwise paid during such period in a transaction in which income, gain, or loss is recognized in full.

"(e) DEFINITIONS.—For purposes of this section—

"(1) DISQUALIFIED INDIVIDUAL.—The term 'disqualified individual' means, with respect to a corporation, any individual who, at any time during the 12-month period beginning on the date which is 6 months before the expatriation date—

"(A) is subject to the requirements of section 16(a) of the Securities Exchange Act of 1934 with respect to such corporation or any member of the expanded affiliated group which includes such corporation, or

"(B) would be subject to such requirements if such corporation or member were an issuer of equity securities referred to in such section.

"(2) EXPATRIATED CORPORATION; EXPATRIATION DATE.—

"(A) EXPATRIATED CORPORATION.—The term 'expatriated corporation' means any corporation which is an expatriated entity (as defined in section 7874(a)(2)). Such term includes any predecessor or successor of such a corporation.

"(B) EXPATRIATION DATE.—The term 'expatriation date' means, with respect to a corporation, the date on which the corporation first becomes an expatriated corporation.

"(3) SPECIFIED STOCK COMPENSATION.—

"(A) IN GENERAL.—The term 'specified stock compensation' means payment (or right to payment) granted by the expatriated corporation (or by any member of the expanded affiliated group which includes such corporation) to any person in connection with the performance of services by a disqualified individual for such corporation or member if the value of such payment or right is based on (or determined by reference to) the value (or change in value) of stock in such corporation (or any such member).

"(B) EXCEPTIONS.—Such term shall not include—

"(i) any option to which part II of subchapter D of chapter 1 applies, or

"(ii) any payment or right to payment from a plan referred to in section 280G(b)(6).

"(4) EXPANDED AFFILIATED GROUP.—The term 'expanded affiliated group' means an affiliated group (as defined in section 1504(a) without regard to section 1504(b)(3)); except that section 1504(a) shall be applied by substituting 'more than 50 percent' for 'at least 80 percent' each place it appears.

"(f) SPECIAL RULES.—For purposes of this section—

"(1) CANCELLATION OF RESTRICTION.—The cancellation of a restriction which by its terms will never lapse shall be treated as a grant.

"(2) PAYMENT OR REIMBURSEMENT OF TAX BY CORPORATION TREATED AS SPECIFIED STOCK COMPENSATION.—Any payment of the tax imposed by this section directly or indirectly by the expatriated corporation or by any member of the expanded affiliated group which includes such corporation—

"(A) shall be treated as specified stock compensation, and

"(B) shall not be allowed as a deduction under any provision of chapter 1.

"(3) CERTAIN RESTRICTIONS IGNORED.—Whether there is specified stock compensation, and the value thereof, shall be determined without regard to any restriction other than a restriction which by its terms will never lapse.

"(4) PROPERTY TRANSFERS.—Any transfer of property shall be treated as a payment and any right to a transfer of property shall be treated as a right to a payment.

"(5) OTHER ADMINISTRATIVE PROVISIONS.—For purposes of subtitle F, any tax imposed by this section shall be treated as a tax imposed by subtitle A.

"(g) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section."

(b) DENIAL OF DEDUCTION.—

(1) IN GENERAL.—Paragraph (6) of section 275(a) is amended by inserting "45," before "46,".

(2) $1,000,000 LIMIT ON DEDUCTIBLE COMPENSATION REDUCED BY PAYMENT OF EXCISE TAX ON SPECIFIED STOCK COMPENSATION.—Paragraph (4) of section 162(m) is amended by adding at the end the following new subparagraph:

"(G) COORDINATION WITH EXCISE TAX ON SPECIFIED STOCK COMPENSATION.—The dollar limitation contained in paragraph (1) with respect to any covered employee shall be reduced (but not below zero) by the amount of any payment (with respect to such employee) of the tax imposed by section 4985 directly or indirectly by the expatriated corporation (as defined in such section) or by any member of the expanded affiliated group (as defined in such section) which includes such corporation."

(c) CONFORMING AMENDMENTS.—

(1) The last sentence of section 3121(v)(2)(A) is amended by inserting before the period "or to any specified stock compensation (as defined in section 4985) on which tax is imposed by section 4985".

(2) The table of chapters for subtitle D is amended by inserting after the item relating to chapter 44 the following new item:

"Chapter 45. Provisions relating to expatriated entities."

(d) EFFECTIVE DATE.—The amendments made by this section shall take effect on March 4, 2003; except that periods before such date shall not be taken into account in applying the periods in subsections (a) and (e)(1) of section 4985 of the Internal Revenue Code of 1986, as added by this section.

**SEC. 603. REINSURANCE OF UNITED STATES RISKS IN FOREIGN JURISDICTIONS.**

(a) IN GENERAL.—Section 845(a) (relating to allocation in case of reinsurance agreement involving tax avoidance or evasion) is amended by striking "source and character" and inserting "amount, source, or character".

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to any risk reinsured after the date of the enactment of this Act.

**SEC. 604. REVISION OF TAX RULES ON EXPATRIATION OF INDIVIDUALS.**

(a) EXPATRIATION TO AVOID TAX.—

(1) IN GENERAL.—Subsection (a) of section 877 (relating to treatment of expatriates) is amended to read as follows:

"(a) TREATMENT OF EXPATRIATES.—

"(1) IN GENERAL.—Every nonresident alien individual to whom this section applies and who, within the 10-year period immediately preceding the close of the taxable year, lost United States citizenship shall be taxable for such taxable year in the manner provided in subsection (b) if the tax imposed pursuant to such subsection (after any reduction in such tax under the last sentence of such subsection) exceeds the tax which, without regard to this section, is imposed pursuant to section 871.

"(2) INDIVIDUALS SUBJECT TO THIS SECTION.—This section shall apply to any individual if—

"(A) the average annual net income tax (as defined in section 38(c)(1)) of such individual for the period of 5 taxable years ending before the date of the loss of United States citizenship is greater than $124,000,

"(B) the net worth of the individual as of such date is $2,000,000 or more, or

"(C) such individual fails to certify under penalty of perjury that he has met the requirements of this title for the 5 preceding taxable years or fails to submit such evidence of such compliance as the Secretary may require.

In the case of the loss of United States citizenship in any calendar year after 2004, such $124,000 amount shall be increased by an amount equal to such dollar amount multiplied by the cost-of-living adjustment determined under section

1(f)(3) for such calendar year by substituting '2003' for '1992' in subparagraph (B) thereof. Any increase under the preceding sentence shall be rounded to the nearest multiple of $1,000.".

(2) REVISION OF EXCEPTIONS FROM ALTERNATIVE TAX.—Subsection (c) of section 877 (relating to tax avoidance not presumed in certain cases) is amended to read as follows:

"(c) EXCEPTIONS.—

"(1) IN GENERAL.—Subparagraphs (A) and (B) of subsection (a)(2) shall not apply to an individual described in paragraph (2) or (3).

"(2) DUAL CITIZENS.—

"(A) IN GENERAL.—An individual is described in this paragraph if—

"(i) the individual became at birth a citizen of the United States and a citizen of another country and continues to be a citizen of such other country, and

"(ii) the individual has had no substantial contacts with the United States.

"(B) SUBSTANTIAL CONTACTS.—An individual shall be treated as having no substantial contacts with the United States only if the individual—

"(i) was never a resident of the United States (as defined in section 7701(b)),

"(ii) has never held a United States passport, and

"(iii) was not present in the United States for more than 30 days during any calendar year which is 1 of the 10 calendar years preceding the individual's loss of United States citizenship.

"(3) CERTAIN MINORS.—An individual is described in this paragraph if—

"(A) the individual became at birth a citizen of the United States,

"(B) neither parent of such individual was a citizen of the United States at the time of such birth,

"(C) the individual's loss of United States citizenship occurs before such individual attains age 18½, and

"(D) the individual was not present in the United States for more than 30 days during any calendar year which is 1 of the 10 calendar years preceding the individual's loss of United States citizenship.".

(3) CONFORMING AMENDMENT.—Section 2107(a) is amended to read as follows:

"(a) TREATMENT OF EXPATRIATES.—A tax computed in accordance with the table contained in section 2001 is hereby imposed on the transfer of the taxable estate, determined as provided in section 2106, of every decedent nonresident not a citizen of the United States if the date of death occurs during a taxable year with respect to which the decedent is subject to tax under section 877(b).".

(b) SPECIAL RULES FOR DETERMINING WHEN AN INDIVIDUAL IS NO LONGER A UNITED STATES CITIZEN OR LONG-TERM RESIDENT.—Section 7701 (relating to definitions) is amended by redesignating subsection (n) as subsection (o) and by inserting after subsection (m) the following new subsection:

"(n) SPECIAL RULES FOR DETERMINING WHEN AN INDIVIDUAL IS NO LONGER A UNITED STATES CITIZEN OR LONG-TERM RESIDENT.—An individual who would (but for this subsection) cease to be treated as a citizen or resident of the United States shall continue to be treated as a citizen or resident of the United States, as the case may be, until such individual—

"(1) gives notice of an expatriating act or termination of residency (with the requisite intent to relinquish citizenship or terminate residency) to the Secretary of State or the Secretary of Homeland Security, and

"(2) provides a statement in accordance with section 6039G.".

(c) PHYSICAL PRESENCE IN THE UNITED STATES FOR MORE THAN 30 DAYS.—Section 877 (relating to expatriation to avoid tax) is amended by adding at the end the following new subsection:

"(g) PHYSICAL PRESENCE.—

"(1) IN GENERAL.—This section shall not apply to any individual to whom this section would otherwise apply for any taxable year during the 10-year period referred to in subsection (a) in which such individual is physically present in the United States at any time on more than 30 days in the calendar year ending in such taxable year, and such individual shall be treated for purposes of this title as a citizen or resident of the United States, as the case may be, for such taxable year.

"(2) EXCEPTION.—

"(A) IN GENERAL.—In the case of an individual described in any of the following subparagraphs of this paragraph, a day of physical presence in the United States shall be disregarded if the individual is performing services in the United States on such day for an employer. The preceding sentence shall not apply if—

"(i) such employer is related (within the meaning of section 267 and 707) to such individual, or

"(ii) such employer fails to meet such requirements as the Secretary may prescribe by regulations to prevent the avoidance of the purposes of this paragraph.

Not more than 30 days during any calendar year may be disregarded under this subparagraph.

"(B) INDIVIDUALS WITH TIES TO OTHER COUNTRIES.—An individual is described in this subparagraph if—

"(i) the individual becomes (not later than the close of a reasonable period after loss of United States citizenship or termination of residency) a citizen or resident of the country in which—

"(I) such individual was born,

"(II) if such individual is married, such individual's spouse was born, or

"(III) either of such individual's parents were born, and

"(ii) the individual becomes fully liable for income tax in such country.

"(C) MINIMAL PRIOR PHYSICAL PRESENCE IN THE UNITED STATES.—An individual is described in this subparagraph if, for each year in the 10-year period ending on the date of loss of United States citizenship or termination of residency, the individual was physically present in the United States for 30 days or less. The rule of section 7701(b)(3)(D)(ii) shall apply for purposes of this subparagraph.".

(d) TRANSFERS SUBJECT TO GIFT TAX.—

(1) IN GENERAL.—Subsection (a) of section 2501 (relating to taxable transfers) is amended by striking paragraph (4), by redesignating paragraph (5) as paragraph (4), and by striking paragraph (3) and inserting the following new paragraph:

"(3) EXCEPTION.—

"(A) CERTAIN INDIVIDUALS.—Paragraph (2) shall not apply in the case of a donor to whom section 877(b) applies for the taxable year which includes the date of the transfer.

"(B) CREDIT FOR FOREIGN GIFT TAXES.—The tax imposed by this section solely by reason of this paragraph shall be credited with the amount of any gift tax actually paid to any foreign country in respect of any gift which is taxable under this section solely by reason of this paragraph."

(2) TRANSFERS OF CERTAIN STOCK.—Subsection (a) of section 2501 is amended by adding at the end the following new paragraph:

"(5) TRANSFERS OF CERTAIN STOCK.—

"(A) IN GENERAL.—In the case of a transfer of stock in a foreign corporation described in subparagraph (B) by a donor to whom section 877(b) applies for the taxable year which includes the date of the transfer—

"(i) section 2511(a) shall be applied without regard to whether such stock is situated within the United States, and

"(ii) the value of such stock for purposes of this chapter shall be its U.S.-asset value determined under subparagraph (C).

"(B) FOREIGN CORPORATION DESCRIBED.—A foreign corporation is described in this subparagraph with respect to a donor if—

"(i) the donor owned (within the meaning of section 958(a)) at the time of such transfer 10 percent or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation, and

"(ii) such donor owned (within the meaning of section 958(a)), or is considered to have owned (by applying the ownership rules of section 958(b)), at the time of such transfer, more than 50 percent of—

"(I) the total combined voting power of all classes of stock entitled to vote of such corporation, or

"(II) the total value of the stock of such corporation.

"(C) U.S.-ASSET VALUE.—For purposes of subparagraph (A), the U.S.-asset value of stock shall be the amount which bears the same ratio to the fair market value of such stock at the time of transfer as—

"(i) the fair market value (at such time) of the assets owned by such foreign corporation and situated in the United States, bears to

"(ii) the total fair market value (at such time) of all assets owned by such foreign corporation."

(e) ENHANCED INFORMATION REPORTING FROM INDIVIDUALS LOSING UNITED STATES CITIZENSHIP.—

(1) IN GENERAL.—Subsection (a) of section 6039G is amended to read as follows:

"(a) IN GENERAL.—Notwithstanding any other provision of law, any individual to whom section 877(b) applies for any taxable year shall provide a statement for such taxable year which includes the information described in subsection (b).".

(2) INFORMATION TO BE PROVIDED.—Subsection (b) of section 6039G is amended to read as follows:

"(b) INFORMATION TO BE PROVIDED.—Information required under subsection (a) shall include—

"(1) the taxpayer's TIN,

"(2) the mailing address of such individual's principal foreign residence,

"(3) the foreign country in which such individual is residing,

"(4) the foreign country of which such individual is a citizen,

"(5) information detailing the income, assets, and liabilities of such individual,

"(6) the number of days during any portion of which that the individual was physically present in the United States during the taxable year, and

"(7) such other information as the Secretary may prescribe.".

(3) INCREASE IN PENALTY.—Subsection (d) of section 6039G is amended to read as follows:

"(d) PENALTY.—If—

"(1) an individual is required to file a statement under subsection (a) for any taxable year, and

"(2) fails to file such a statement with the Secretary on or before the date such statement is required to be filed or fails to include all the information required to be shown on the statement or includes incorrect information,

such individual shall pay a penalty of $10,000 unless it is shown that such failure is due to reasonable cause and not to willful neglect.".

(4) CONFORMING AMENDMENT.—Section 6039G is amended by striking subsections (c), (f), and (g) and by redesignating subsections (d) and (e) as subsection (c) and (d), respectively.

(f) EFFECTIVE DATE.—The amendments made by this section shall apply to individuals who expatriate after June 3, 2004.

**SEC. 605. REPORTING OF TAXABLE MERGERS AND ACQUISITIONS.**

(a) IN GENERAL.—Subpart B of part III of subchapter A of chapter 61 is amended by inserting after section 6043 the following new section:

**"SEC. 6043A. RETURNS RELATING TO TAXABLE MERGERS AND ACQUISITIONS.**

"(a) IN GENERAL.—According to the forms or regulations prescribed by the Secretary, the acquiring corporation in any taxable acquisition shall make a return setting forth—

"(1) a description of the acquisition,

"(2) the name and address of each shareholder of the acquired corporation who is required to recognize gain (if any) as a result of the acquisition,

"(3) the amount of money and the fair market value of other property transferred to each such shareholder as part of such acquisition, and

"(4) such other information as the Secretary may prescribe.

To the extent provided by the Secretary, the requirements of this section applicable to the acquiring corporation shall be applicable to the acquired corporation and not to the acquiring corporation.

"(b) NOMINEES.—According to the forms or regulations prescribed by the Secretary—

"(1) REPORTING.—Any person who holds stock as a nominee for another person shall furnish in the manner prescribed by the Secretary to such other person the information provided by the corporation under subsection (d).

"(2) REPORTING TO NOMINEES.—In the case of stock held by any person as a nominee, references in this section (other than in subsection (c)) to a shareholder shall be treated as a reference to the nominee.

"(c) TAXABLE ACQUISITION.—For purposes of this section, the term 'taxable acquisition' means any acquisition by a corporation of stock in or property of another corporation if any shareholder of the acquired corporation is required to recognize gain (if any) as a result of such acquisition.

"(d) STATEMENTS TO BE FURNISHED TO SHAREHOLDERS.—According to the forms or regulations prescribed by the Secretary, every person required to make a return under subsection (a) shall furnish to each shareholder whose name is required to be set forth in such return a written statement showing—

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

"(2) the information required to be shown on such return with respect to such shareholder, and

"(3) such other information as the Secretary may prescribe.

The written statement required under the preceding sentence shall be furnished to the shareholder on or before January 31 of the year following the calendar year during which the taxable acquisition occurred."

(b) ASSESSABLE PENALTIES.—

(1) Subparagraph (B) of section 6724(d)(1) (relating to definitions) is amended by redesignating clauses (ii) through (xviii) as clauses (iii) through (xix), respectively, and by inserting after clause (i) the following new clause:

"(ii) section 6043A(a) (relating to returns relating to taxable mergers and acquisitions),".

(2) Paragraph (2) of section 6724(d) is amended by redesignating subparagraphs (F) through (BB) as subparagraphs (G) through (CC), respectively, and by inserting after subparagraph (E) the following new subparagraph:

"(F) subsections (b) and (d) of section 6043A (relating to returns relating to taxable mergers and acquisitions).".

(c) CLERICAL AMENDMENT.—The table of sections for subpart B of part III of subchapter A of chapter 61 is amended by inserting after the item relating to section 6043 the following new item:

"Sec. 6043A. Returns relating to taxable mergers and acquisitions.".

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to acquisitions after the date of the enactment of this Act.

**SEC. 606. STUDIES.**

(a) TRANSFER PRICING RULES.—The Secretary of the Treasury or the Secretary's delegate shall conduct a study regarding the effectiveness of current transfer pricing rules and compliance efforts in ensuring that cross-border transfers and other related-party transactions, particularly transactions involving intangible assets, service contracts, or leases cannot be used improperly to shift income out of the United States. The study shall include a review of the contemporaneous documentation and penalty rules under section 6662 of the Internal Revenue Code of 1986, a review of the regulatory and administrative guidance implementing the principles of section 482 of such Code to transactions involving intangible property and services and to cost-sharing arrangements, and an examination of whether increased disclosure of cross-border transactions should be required. The study shall set forth specific recommendations to address all abuses identified in the study. Not later than June 30, 2005, such Secretary or delegate shall submit to the Congress a report of such study.

(b) INCOME TAX TREATIES.—The Secretary of the Treasury or the Secretary's delegate shall conduct a study of United States income tax treaties to identify any inappropriate reductions in United States withholding tax that provide opportunities for shifting income out of the United States, and to evaluate whether existing anti-abuse mechanisms are operating properly. The study shall include specific recommendations to address all inappropriate uses of tax treaties. Not later than June 30, 2005, such Secretary or delegate shall submit to the Congress a report of such study.

(c) IMPACT OF CORPORATE EXPATRIATION PROVISIONS.—The Secretary of the Treasury or the Secretary's delegate shall conduct a study of the impact of the provisions of this title on corporate expatriation. The study shall include such recommendations as such Secretary or delegate may have to improve the impact of such provisions in carrying out the purposes of this title. Not later than December 31, 2005, such Secretary or delegate shall submit to the Congress a report of such study.

# Subtitle B—Provisions Relating to Tax Shelters

## Part I—Taxpayer-Related Provisions

**SEC. 611. PENALTY FOR FAILING TO DISCLOSE REPORTABLE TRANSACTIONS.**

(a) IN GENERAL.—Part I of subchapter B of chapter 68 (relating to assessable penalties) is amended by inserting after section 6707 the following new section:

**"SEC. 6707A. PENALTY FOR FAILURE TO INCLUDE REPORTABLE TRANSACTION INFORMATION WITH RETURN.**

"(a) IMPOSITION OF PENALTY.—Any person who fails to include on any return or statement any information with respect to a reportable transaction which is required under section 6011 to be included with such return or statement shall pay a penalty in the amount determined under subsection (b).

"(b) AMOUNT OF PENALTY.—

"(1) IN GENERAL.—Except as provided in paragraph (2), the amount of the penalty under subsection (a) shall be—

"(A) $10,000 in the case of a natural person, and

"(B) $50,000 in any other case.

"(2) LISTED TRANSACTION.—The amount of the penalty under subsection (a) with respect to a listed transaction shall be—

"(A) $100,000 in the case of a natural person, and

"(B) $200,000 in any other case.

"(c) DEFINITIONS.—For purposes of this section—

"(1) REPORTABLE TRANSACTION.—The term 'reportable transaction' means any transaction with respect to which information is required to be included with a return or statement because, as determined under regulations prescribed under section 6011, such transaction is of a type which the Secretary determines as having a potential for tax avoidance or evasion.

"(2) LISTED TRANSACTION.—The term 'listed transaction' means a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011.

"(d) AUTHORITY TO RESCIND PENALTY.—

"(1) IN GENERAL.—The Commissioner of Internal Revenue may rescind all or any portion of any penalty imposed by this section with respect to any violation if—

"(A) the violation is with respect to a reportable transaction other than a listed transaction, and

"(B) rescinding the penalty would promote compliance with the requirements of this title and effective tax administration.

"(2) NO JUDICIAL APPEAL.—Notwithstanding any other provision of law, any determination under this subsection may not be reviewed in any judicial proceeding.

"(3) RECORDS.—If a penalty is rescinded under paragraph (1), the Commissioner shall place in the file in the Office of the Commissioner the opinion of the Commissioner or the head of the Office of Tax Shelter Analysis with respect to the determination, including—

"(A) a statement of the facts and circumstances relating to the violation,

"(B) the reasons for the rescission, and

"(C) the amount of the penalty rescinded.

"(e) COORDINATION WITH OTHER PENALTIES.—The penalty imposed by this section shall be in addition to any other penalty imposed by this title."

(b) CONFORMING AMENDMENT.—The table of sections for part I of subchapter B of chapter 68 is amended by inserting after the item relating to section 6707 the following:

"Sec. 6707A. Penalty for failure to include reportable transaction information with return."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to returns and statements the due date for which is after the date of the enactment of this Act.

(d) REPORT.—The Commissioner of Internal Revenue shall annually report to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate—

(1) a summary of the total number and aggregate amount of penalties imposed, and rescinded, under section 6707A of the Internal Revenue Code of 1986, and

(2) a description of each penalty rescinded under section 6707(c) of such Code and the reasons therefor.

**SEC. 612. ACCURACY-RELATED PENALTY FOR LISTED TRANSACTIONS, OTHER REPORTABLE TRANSACTIONS HAVING A SIGNIFICANT TAX AVOIDANCE PURPOSE, ETC.**

(a) IN GENERAL.—Subchapter A of chapter 68 is amended by inserting after section 6662 the following new section:

**"SEC. 6662A. IMPOSITION OF ACCURACY-RELATED PENALTY ON UNDERSTATEMENTS WITH RESPECT TO REPORTABLE TRANSACTIONS.**

"(a) IMPOSITION OF PENALTY.—If a taxpayer has a reportable transaction understatement for any taxable year, there shall be added to the tax an amount equal to 20 percent of the amount of such understatement.

"(b) REPORTABLE TRANSACTION UNDERSTATEMENT.—For purposes of this section—

"(1) IN GENERAL.—The term 'reportable transaction understatement' means the sum of—

"(A) the product of—

"(i) the amount of the increase (if any) in taxable income which results from a difference between the proper tax treatment of an item to which this section applies and the taxpayer's treatment of such item (as shown on the taxpayer's return of tax), and

"(ii) the highest rate of tax imposed by section 1 (section 11 in the case of a taxpayer which is a corporation), and

"(B) the amount of the decrease (if any) in the aggregate amount of credits determined under subtitle A which results from a difference between the taxpayer's treatment of an item to which this section applies (as shown on the taxpayer's return of tax) and the proper tax treatment of such item.

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

"(2) ITEMS TO WHICH SECTION APPLIES.—This section shall apply to any item which is attributable to—

"(A) any listed transaction, and

"(B) any reportable transaction (other than a listed transaction) if a significant purpose of such transaction is the avoidance or evasion of Federal income tax.

"(c) HIGHER PENALTY FOR NONDISCLOSED TRANSACTIONS.—Subsection (a) shall be applied by substituting '30 percent' for '20 percent' with respect to the portion of any reportable transaction understatement with respect to which the requirement of section 6664(d)(2)(A) is not met.

"(d) DEFINITIONS OF REPORTABLE AND LISTED TRANSACTIONS.—For purposes of this section, the terms 'reportable transaction' and 'listed transaction' have the respective meanings given to such terms by section 6707A(c).

"(e) SPECIAL RULES.—

"(1) COORDINATION WITH PENALTIES, ETC., ON OTHER UNDERSTATEMENTS.—In the case of an understatement (as defined in section 6662(d)(2))—

"(A) the amount of such understatement (determined without regard to this paragraph) shall be increased by the aggregate amount of reportable transaction understatements for purposes of determining whether such understatement is a substantial understatement under section 6662(d)(1), and

"(B) the addition to tax under section 6662(a) shall apply only to the excess of the amount of the substantial understatement (if any) after the application of subparagraph (A) over the aggregate amount of reportable transaction understatements.

"(2) COORDINATION WITH OTHER PENALTIES.—

"(A) APPLICATION OF FRAUD PENALTY.—References to an underpayment in section 6663 shall be treated as including references to a reportable transaction understatement.

"(B) NO DOUBLE PENALTY.—This section shall not apply to any portion of an understatement on which a penalty is imposed under section 6663.

"(3) SPECIAL RULE FOR AMENDED RETURNS.—Except as provided in regulations, in no event shall any tax treatment included with an amendment or supplement to a return of tax be taken into account in determining the amount of any reportable transaction understatement if the amendment or supplement is filed after the earlier of the date the taxpayer is first contacted by the Secretary regarding the examination of the return or such other date as is specified by the Secretary."

(b) DETERMINATION OF OTHER UNDERSTATEMENTS.—Subparagraph (A) of section 6662(d)(2) is amended by adding at the end the following flush sentence:

"The excess under the preceding sentence shall be determined without regard to items to which section 6662A applies."

(c) REASONABLE CAUSE EXCEPTION.—

(1) IN GENERAL.—Section 6664 is amended by adding at the end the following new subsection:

"(d) REASONABLE CAUSE EXCEPTION FOR REPORTABLE TRANSACTION UNDERSTATEMENTS.—

"(1) IN GENERAL.—No penalty shall be imposed under section 6662A with respect to any portion of a reportable transaction understatement if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.

"(2) SPECIAL RULES.—Paragraph (1) shall not apply to any reportable transaction understatement unless—

"(A) the relevant facts affecting the tax treatment of the item are adequately disclosed in accordance with the regulations prescribed under section 6011,

"(B) there is or was substantial authority for such treatment, and

"(C) the taxpayer reasonably believed that such treatment was more likely than not the proper treatment.

A taxpayer failing to adequately disclose in accordance with section 6011 shall be treated as meeting the requirements of subparagraph (A) if the penalty for such failure was rescinded under section 6707A(d).

"(3) RULES RELATING TO REASONABLE BELIEF.—For purposes of paragraph (2)(C)—

"(A) IN GENERAL.—A taxpayer shall be treated as having a reasonable belief with respect to the tax treatment of an item only if such belief—

"(i) is based on the facts and law that exist at the time the return of tax which includes such tax treatment is filed, and

"(ii) relates solely to the taxpayer's chances of success on the merits of such treatment and does not take into account the possibility that a return will not be audited, such treatment will not be raised on audit, or such treatment will be resolved through settlement if it is raised.

"(B) CERTAIN OPINIONS MAY NOT BE RELIED UPON.—

"(i) IN GENERAL.—An opinion of a tax advisor may not be relied upon to establish the reasonable belief of a taxpayer if—

"(I) the tax advisor is described in clause (ii), or

"(II) the opinion is described in clause (iii).

"(ii) DISQUALIFIED TAX ADVISORS.—A tax advisor is described in this clause if the tax advisor—

"(I) is a material advisor (within the meaning of section 6111(b)(1)) and participates in the organization, management, promotion, or sale of the transaction or is related (within the meaning of section 267(b) or 707(b)(1)) to any person who so participates,

"(II) is compensated directly or indirectly by a material advisor with respect to the transaction,

"(III) has a fee arrangement with respect to the transaction which is contingent on all or part of the intended tax benefits from the transaction being sustained, or

"(IV) as determined under regulations prescribed by the Secretary, has a disqualifying financial interest with respect to the transaction.

"(iii) DISQUALIFIED OPINIONS.—For purposes of clause (i), an opinion is disqualified if the opinion—

"(I) is based on unreasonable factual or legal assumptions (including assumptions as to future events),

"(II) unreasonably relies on representations, statements, findings, or agreements of the taxpayer or any other person,

"(III) does not identify and consider all relevant facts, or

"(IV) fails to meet any other requirement as the Secretary may prescribe."

(2) CONFORMING AMENDMENTS.—

(A) Paragraph (1) of section 6664(c) is amended by striking "this part" and inserting "section 6662 or 6663".

(B) The heading for subsection (c) of section 6664 is amended by inserting "FOR UNDERPAYMENTS" after "EXCEPTION".

(d) REDUCTION IN PENALTY FOR SUBSTANTIAL UNDERSTATEMENT OF INCOME TAX NOT TO APPLY TO TAX SHELTERS.—Subparagraph (C) of section 6662(d)(2) (relating to substantial understatement of income tax) is amended to read as follows:

"(C) REDUCTION NOT TO APPLY TO TAX SHELTERS.—

"(i) IN GENERAL.—Subparagraph (B) shall not apply to any item attributable to a tax shelter.

"(ii) TAX SHELTER.—For purposes of clause (i), the term 'tax shelter' means—

"(I) a partnership or other entity,

"(II) any investment plan or arrangement, or

"(III) any other plan or arrangement,

if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax."

(e) CONFORMING AMENDMENTS.—

(1) Sections 461(i)(3)(C), 1274(b)(3), and 7525(b) are each amended by striking "section 6662(d)(2)(C)(iii)" and inserting "section 6662(d)(2)(C)(ii)".

(2) The heading for section 6662 is amended to read as follows:

**"SEC. 6662. IMPOSITION OF ACCURACY-RELATED PENALTY ON UNDERPAYMENTS."**

(3) The table of sections for part II of subchapter A of chapter 68 is amended by striking the item relating to section 6662 and inserting the following new items:

"Sec. 6662. Imposition of accuracy-related penalty on underpayments.
"Sec. 6662A. Imposition of accuracy-related penalty on understatements with respect to reportable transactions."

(f) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years ending after the date of the enactment of this Act.

**SEC. 613. TAX SHELTER EXCEPTION TO CONFIDENTIALITY PRIVILEGES RELATING TO TAXPAYER COMMUNICATIONS.**

(a) IN GENERAL.—Section 7525(b) (relating to section not to apply to communications regarding corporate tax shelters) is amended to read as follows:

"(b) SECTION NOT TO APPLY TO COMMUNICATIONS REGARDING TAX SHELTERS.—The privilege under subsection (a) shall not apply to any written communication which is—

"(1) between a federally authorized tax practitioner and—

"(A) any person,

"(B) any director, officer, employee, agent, or representative of the person, or

"(C) any other person holding a capital or profits interest in the person, and

"(2) in connection with the promotion of the direct or indirect participation of the person in any tax shelter (as defined in section 6662(d)(2)(C)(ii))."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to communications made on or after the date of the enactment of this Act.

**SEC. 614. STATUTE OF LIMITATIONS FOR TAXABLE YEARS FOR WHICH REQUIRED LISTED TRANSACTIONS NOT REPORTED.**

(a) IN GENERAL.—Section 6501(c) (relating to exceptions) is amended by adding at the end the following new paragraph:

"(10) LISTED TRANSACTIONS.—If a taxpayer fails to include on any return or statement for any taxable year any information with respect to a listed transaction (as defined in section 6707A(c)(2)) which is required under section 6011 to be included with such return or statement, the time for assessment of any tax imposed by this title with respect to such transaction shall not expire before the date which is 1 year after the earlier of—

"(A) the date on which the Secretary is furnished the information so required, or

"(B) the date that a material advisor (as defined in section 6111) meets the requirements of section 6112 with respect to a request by the Secretary under section 6112(b) relating to such transaction with respect to such taxpayer."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years with respect to which the period for assessing a deficiency did not expire before the date of the enactment of this Act.

**SEC. 615. DISCLOSURE OF REPORTABLE TRANSACTIONS.**

(a) IN GENERAL.—Section 6111 (relating to registration of tax shelters) is amended to read as follows:

**"SEC. 6111. DISCLOSURE OF REPORTABLE TRANSACTIONS.**

"(a) IN GENERAL.—Each material advisor with respect to any reportable transaction shall make a return (in such form as the Secretary may prescribe) setting forth—

"(1) information identifying and describing the transaction,

"(2) information describing any potential tax benefits expected to result from the transaction, and

"(3) such other information as the Secretary may prescribe.

Such return shall be filed not later than the date specified by the Secretary.

"(b) DEFINITIONS.—For purposes of this section—

"(1) MATERIAL ADVISOR.—

"(A) IN GENERAL.—The term 'material advisor' means any person—

"(i) who provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, or carrying out any reportable transaction, and

"(ii) who directly or indirectly derives gross income in excess of the threshold amount (or such other amount as may be prescribed by the Secretary) for such advice or assistance.

"(B) THRESHOLD AMOUNT.—For purposes of subparagraph (A), the threshold amount is—

"(i) $50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons, and

"(ii) $250,000 in any other case.

"(2) REPORTABLE TRANSACTION.—The term 'reportable transaction' has the meaning given to such term by section 6707A(c).

"(c) REGULATIONS.—The Secretary may prescribe regulations which provide—

"(1) that only 1 person shall be required to meet the requirements of subsection (a) in cases in which 2 or more persons would otherwise be required to meet such requirements,

"(2) exemptions from the requirements of this section, and

"(3) such rules as may be necessary or appropriate to carry out the purposes of this section."

(b) CONFORMING AMENDMENTS.—

(1) The item relating to section 6111 in the table of sections for subchapter B of chapter 61 is amended to read as follows:

"Sec. 6111. Disclosure of reportable transactions."

(2) So much of section 6112 as precedes subsection (c) thereof is amended to read as follows:

**"SEC. 6112. MATERIAL ADVISORS OF REPORTABLE TRANSACTIONS MUST KEEP LISTS OF ADVISEES, ETC.**

"(a) IN GENERAL.—Each material advisor (as defined in section 6111) with respect to any reportable transaction (as defined in section 6707A(c)) shall (whether or not required to file a return under section 6111 with respect to such transaction) maintain (in such manner as the Secretary may by regulations prescribe) a list—

"(1) identifying each person with respect to whom such advisor acted as a material advisor with respect to such transaction, and

"(2) containing such other information as the Secretary may by regulations require."

(3) Section 6112 is amended—

(A) by redesignating subsection (c) as subsection (b),

(B) by inserting "written" before "request" in subsection (b)(1) (as so redesignated), and

(C) by striking "shall prescribe" in subsection (b)(2) (as so redesignated) and inserting "may prescribe".

(4) The item relating to section 6112 in the table of sections for subchapter B of chapter 61 is amended to read as follows:

"Sec. 6112. Material advisors of reportable transactions must keep lists of advisees, etc."

(5)(A) The heading for section 6708 is amended to read as follows:

**"SEC. 6708. FAILURE TO MAINTAIN LISTS OF ADVISEES WITH RESPECT TO REPORTABLE TRANSACTIONS."**

(B) The item relating to section 6708 in the table of sections for part I of subchapter B of chapter 68 is amended to read as follows:

"Sec. 6708. Failure to maintain lists of advisees with respect to reportable transactions."

(c) REQUIRED DISCLOSURE NOT SUBJECT TO CLAIM OF CONFIDENTIALITY.—Paragraph (1) of section 6112(b), as redesignated by subsection (b), is amended by adding at the end the following new flush sentence:

"For purposes of this section, the identity of any person on such list shall not be privileged.".

(d) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to transactions with respect to which material aid, assistance, or advice referred to in section 6111(b)(1)(A)(i) of the Internal Revenue Code of 1986 (as added by this section) is provided after the date of the enactment of this Act.

(2) NO CLAIM OF CONFIDENTIALITY AGAINST DISCLOSURE.—The amendment made by subsection (c) shall take effect as if included in the amendments made by section 142 of the Deficit Reduction Act of 1984.

**SEC. 616. FAILURE TO FURNISH INFORMATION REGARDING REPORTABLE TRANSACTIONS.**

(a) IN GENERAL.—Section 6707 (relating to failure to furnish information regarding tax shelters) is amended to read as follows:

**"SEC. 6707. FAILURE TO FURNISH INFORMATION REGARDING REPORTABLE TRANSACTIONS.**

"(a) IN GENERAL.—If a person who is required to file a return under section 6111(a) with respect to any reportable transaction—

"(1) fails to file such return on or before the date prescribed therefor, or

"(2) files false or incomplete information with the Secretary with respect to such transaction,

such person shall pay a penalty with respect to such return in the amount determined under subsection (b).

"(b) AMOUNT OF PENALTY.—

"(1) IN GENERAL.—Except as provided in paragraph (2), the penalty imposed under subsection (a) with respect to any failure shall be $50,000.

"(2) LISTED TRANSACTIONS.—The penalty imposed under subsection (a) with respect to any listed transaction shall be an amount equal to the greater of—

"(A) $200,000, or

"(B) 50 percent of the gross income derived by such person with respect to aid, assistance, or advice which is provided with respect to the listed transaction before the date the return is filed under section 6111.

Subparagraph (B) shall be applied by substituting '75 percent' for '50 percent' in the case of an intentional failure or act described in subsection (a).

"(c) RESCISSION AUTHORITY.—The provisions of section 6707A(d) (relating to authority of Commissioner to rescind penalty) shall apply to any penalty imposed under this section.

"(d) REPORTABLE AND LISTED TRANSACTIONS.—For purposes of this section, the terms 'reportable transaction' and 'listed transaction' have the respective meanings given to such terms by section 6707A(c)."

(b) CLERICAL AMENDMENT.—The item relating to section 6707 in the table of sections for part I of subchapter B of chapter 68 is amended by striking "tax shelters" and inserting "reportable transactions".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to returns the due date for which is after the date of the enactment of this Act.

**SEC. 617. MODIFICATION OF PENALTY FOR FAILURE TO MAINTAIN LISTS OF INVESTORS.**

(a) IN GENERAL.—Subsection (a) of section 6708 is amended to read as follows:

"(a) IMPOSITION OF PENALTY.—

"(1) IN GENERAL.—If any person who is required to maintain a list under section 6112(a) fails to make such list available upon written request to the Secretary in accordance with section 6112(b) within 20 business days after the date of such request, such person shall pay a penalty of $10,000 for each day of such failure after such 20th day.

"(2) REASONABLE CAUSE EXCEPTION.—No penalty shall be imposed by paragraph (1) with respect to the failure on any day if such failure is due to reasonable cause.".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to requests made after the date of the enactment of this Act.

**SEC. 618. PENALTY ON PROMOTERS OF TAX SHELTERS.**

(a) PENALTY ON PROMOTING ABUSIVE TAX SHELTERS.—Section 6700(a) is amended by adding at the end the following new sentence: "Notwithstanding the first sentence, if an activity with respect to which a penalty imposed under this subsection involves a statement described in paragraph (2)(A), the amount of the penalty shall be equal to 50 percent of the gross income derived (or to be derived) from such activity by the person on which the penalty is imposed."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to activities after the date of the enactment of this Act.

**SEC. 619. MODIFICATIONS OF SUBSTANTIAL UNDERSTATEMENT PENALTY FOR NONREPORTABLE TRANSACTIONS.**

(a) SUBSTANTIAL UNDERSTATEMENT OF CORPORATIONS.—Section 6662(d)(1)(B) (relating to special rule for corporations) is amended to read as follows:

"(B) SPECIAL RULE FOR CORPORATIONS.—In the case of a corporation other than an S corporation or a personal holding company (as defined in section 542), there is a substantial understatement of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the lesser of—

"(i) 10 percent of the tax required to be shown on the return for the taxable year (or, if greater, $10,000), or

"(ii) $10,000,000."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

**SEC. 620. MODIFICATION OF ACTIONS TO ENJOIN CERTAIN CONDUCT RELATED TO TAX SHELTERS AND REPORTABLE TRANSACTIONS.**

(a) IN GENERAL.—Section 7408 (relating to action to enjoin promoters of abusive tax shelters, etc.) is amended by redesignating subsection (c) as subsection (d) and by striking subsections (a) and (b) and inserting the following new subsections:

"(a) AUTHORITY TO SEEK INJUNCTION.—A civil action in the name of the United States to enjoin any person from further engaging in specified conduct may be commenced at the request of the Secretary. Any action under this section shall be brought in the district court of the United States for the district in which such person resides, has his principal place of business, or has engaged in specified conduct. The court may exercise its jurisdiction over such action (as provided in section 7402(a)) separate and apart from any other action brought by the United States against such person.

"(b) ADJUDICATION AND DECREE.—In any action under subsection (a), if the court finds—

"(1) that the person has engaged in any specified conduct, and

"(2) that injunctive relief is appropriate to prevent recurrence of such conduct, the court may enjoin such person from engaging in such conduct or in any other activity subject to penalty under this title.

"(c) SPECIFIED CONDUCT.—For purposes of this section, the term 'specified conduct' means any action, or failure to take action, subject to penalty under section 6700, 6701, 6707, or 6708."

(b) CONFORMING AMENDMENTS.—

(1) The heading for section 7408 is amended to read as follows:

**"SEC. 7408. ACTIONS TO ENJOIN SPECIFIED CONDUCT RELATED TO TAX SHELTERS AND REPORTABLE TRANSACTIONS."**

(2) The table of sections for subchapter A of chapter 76 is amended by striking the item relating to section 7408 and inserting the following new item:

"Sec. 7408. Actions to enjoin specified conduct related to tax shelters and reportable transactions."

(c) EFFECTIVE DATE.—The amendment made by this section shall take effect on the day after the date of the enactment of this Act.

**SEC. 621. PENALTY ON FAILURE TO REPORT INTERESTS IN FOREIGN FINANCIAL ACCOUNTS.**

(a) IN GENERAL.—Section 5321(a)(5) of title 31, United States Code, is amended to read as follows:

"(5) FOREIGN FINANCIAL AGENCY TRANSACTION VIOLATION.—

"(A) PENALTY AUTHORIZED.—The Secretary of the Treasury may impose a civil money penalty on any person who violates, or causes any violation of, any provision of section 5314.

"(B) AMOUNT OF PENALTY.—

"(i) IN GENERAL.—Except as provided in subparagraph (C), the amount of any civil penalty imposed under subparagraph (A) shall not exceed $5,000.

"(ii) REASONABLE CAUSE EXCEPTION.—No penalty shall be imposed under subparagraph (A) with respect to any violation if—

"(I) such violation was due to reasonable cause, and

"(II) the amount of the transaction or the balance in the account at the time of the transaction was properly reported.

"(C) WILLFUL VIOLATIONS.—In the case of any person willfully violating, or willfully causing any violation of, any provision of section 5314—

"(i) the maximum penalty under subparagraph (B)(i) shall be increased to the greater of—

"(I) $25,000, or

"(II) the amount (not exceeding $100,000) determined under subparagraph (D), and

"(ii) subparagraph (B)(ii) shall not apply.

"(D) AMOUNT.—The amount determined under this subparagraph is—

"(i) in the case of a violation involving a transaction, the amount of the transaction, or

"(ii) in the case of a violation involving a failure to report the existence of an account or any identifying information required to be provided with respect to an account, the balance in the account at the time of the violation."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to violations occurring after the date of the enactment of this Act.

**SEC. 622. REGULATION OF INDIVIDUALS PRACTICING BEFORE THE DEPARTMENT OF THE TREASURY.**

(a) CENSURE; IMPOSITION OF PENALTY.—

(1) IN GENERAL.—Section 330(b) of title 31, United States Code, is amended—

(A) by inserting ", or censure," after "Department", and

(B) by adding at the end the following new flush sentence:

"The Secretary may impose a monetary penalty on any representative described in the preceding sentence. If the representative was acting on behalf of an employer or any firm or other entity in connection with the conduct giving rise to such penalty, the Secretary may impose a monetary penalty on such employer, firm, or entity if it knew, or reasonably should have known, of such conduct. Such penalty shall not exceed the gross income derived (or to be derived) from the conduct giving rise to the penalty. Any such penalty imposed on an individual may be in addition to, or in lieu of, any suspension, disbarment, or censure of such individual."

(2) EFFECTIVE DATE.—The amendments made by this subsection shall apply to actions taken after the date of the enactment of this Act.

(b) TAX SHELTER OPINIONS, ETC.—Section 330 of such title 31 is amended by adding at the end the following new subsection:

"(d) Nothing in this section or in any other provision of law shall be construed to limit the authority of the Secretary of the Treasury to impose standards applicable to the rendering of written advice with respect to any entity, transaction plan or arrangement, or other plan or arrangement, which is of a type which the Secretary determines as having a potential for tax avoidance or evasion."

## Part II—Other Provisions

**SEC. 631. TREATMENT OF STRIPPED INTERESTS IN BOND AND PREFERRED STOCK FUNDS, ETC.**

(a) IN GENERAL.—Section 1286 (relating to tax treatment of stripped bonds) is amended by redesignating subsection (f) as subsection (g) and by inserting after subsection (e) the following new subsection:

"(f) TREATMENT OF STRIPPED INTERESTS IN BOND AND PREFERRED STOCK FUNDS, ETC.—In the case of an account or entity substantially all of the assets of which consist of bonds, preferred stock, or a combination thereof, the Secretary may by regulations provide that rules similar to the rules of this section and 305(e), as appropriate, shall apply to interests in such account or entity to which (but for this subsection) this section or section 305(e), as the case may be, would not apply."

(b) CROSS REFERENCE.—Subsection (e) of section 305 is amended by adding at the end the following new paragraph:

"(7) CROSS REFERENCE.—

**"For treatment of stripped interests in certain accounts or entities holding preferred stock, see section 1286(f)."**

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to purchases and dispositions after the date of the enactment of this Act.

**SEC. 632. MINIMUM HOLDING PERIOD FOR FOREIGN TAX CREDIT ON WITHHOLDING TAXES ON INCOME OTHER THAN DIVIDENDS.**

(a) IN GENERAL.—Section 901 is amended by redesignating subsection (l) as subsection (m) and by inserting after subsection (k) the following new subsection:

"(l) MINIMUM HOLDING PERIOD FOR WITHHOLDING TAXES ON GAIN AND INCOME OTHER THAN DIVIDENDS ETC.—

"(1) IN GENERAL.—In no event shall a credit be allowed under subsection (a) for any withholding tax (as defined in subsection (k)) on any item of income or gain with respect to any property if—

"(A) such property is held by the recipient of the item for 15 days or less during the 30-day period beginning on the date which is 15 days before the date on which the right to receive payment of such item arises, or

"(B) to the extent that the recipient of the item is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

This paragraph shall not apply to any dividend to which subsection (k) applies.

"(2) EXCEPTION FOR TAXES PAID BY DEALERS.—

"(A) IN GENERAL.—Paragraph (1) shall not apply to any qualified tax with respect to any property held in the active conduct in a foreign country of a business as a dealer in such property.

"(B) QUALIFIED TAX.—For purposes of subparagraph (A), the term 'qualified tax' means a tax paid to a foreign country (other than the foreign country referred to in subparagraph (A)) if—

"(i) the item to which such tax is attributable is subject to taxation on a net basis by the country referred to in subparagraph (A), and

"(ii) such country allows a credit against its net basis tax for the full amount of the tax paid to such other foreign country.

"(C) DEALER.—For purposes of subparagraph (A), the term 'dealer' means—

"(i) with respect to a security, any person to whom paragraphs (1) and (2) of subsection (k) would not apply by reason of paragraph (4) thereof if such security were stock, and

"(ii) with respect to any other property, any person with respect to whom such property is described in section 1221(a)(1).

"(D) REGULATIONS.—The Secretary may prescribe such regulations as may be appropriate to carry out this paragraph, including regulations to prevent the abuse of the exception provided by this paragraph and to treat other taxes as qualified taxes.

"(3) EXCEPTIONS.—The Secretary may by regulation provide that paragraph (1) shall not apply to property where the Secretary determines that the application of paragraph (1) to such property is not necessary to carry out the purposes of this subsection.

"(4) CERTAIN RULES TO APPLY.—Rules similar to the rules of paragraphs (5), (6), and (7) of subsection (k) shall apply for purposes of this subsection.

"(5) DETERMINATION OF HOLDING PERIOD.—Holding periods shall be determined for purposes of this subsection without regard to section 1235 or any similar rule."

(b) CONFORMING AMENDMENT.—The heading of subsection (k) of section 901 is amended by inserting "ON DIVIDENDS" after "TAXES".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to amounts paid or accrued more than 30 days after the date of the enactment of this Act.

**SEC. 633. DISALLOWANCE OF CERTAIN PARTNERSHIP LOSS TRANSFERS.**

(a) TREATMENT OF CONTRIBUTED PROPERTY WITH BUILT-IN LOSS.—Paragraph (1) of section 704(c) is amended by striking "and" at the end of subparagraph (A), by striking the period at the end of subparagraph (B) and inserting ", and", and by adding at the end the following:

"(C) if any property so contributed has a built-in loss—

"(i) such built-in loss shall be taken into account only in determining the amount of items allocated to the contributing partner, and

"(ii) except as provided in regulations, in determining the amount of items allocated to other partners, the basis of the contributed property in the hands of the partnership shall be treated as being equal to its fair market value at the time of contribution.

For purposes of subparagraph (C), the term 'built-in loss' means the excess of the adjusted basis of the property (determined without regard to subparagraph (C)(ii)) over its fair market value at the time of contribution."

(b) SPECIAL RULES FOR TRANSFERS OF PARTNERSHIP INTEREST IF THERE IS SUBSTANTIAL BUILT-IN LOSS.—

(1) ADJUSTMENT OF PARTNERSHIP BASIS REQUIRED.—Subsection (a) of section 743 (relating to optional adjustment to basis of partnership property) is amended by inserting before the period "or unless the partnership has a substantial built-in loss immediately after such transfer".

(2) ADJUSTMENT.—Subsection (b) of section 743 is amended by inserting "or which has a substantial built-in loss immediately after such transfer" after "section 754 is in effect".

(3) SUBSTANTIAL BUILT-IN LOSS.—Section 743 is amended by adding at the end the following new subsection:

"(d) SUBSTANTIAL BUILT-IN LOSS.—

"(1) IN GENERAL.—For purposes of this section, a partnership has a substantial built-in loss with respect to a transfer of an interest in a partnership if the partnership's adjusted basis in the partnership property exceeds by more than $250,000 the fair market value of such property.

"(2) REGULATIONS.—The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of paragraph (1) and section 734(d), including regulations aggregating related partnerships and disregarding property acquired by the partnership in an attempt to avoid such purposes."

(4) ALTERNATIVE RULES FOR ELECTING INVESTMENT PARTNERSHIPS.—

(A) IN GENERAL.—Section 743 is amended by adding at the end the following new subsection:

"(e) ALTERNATIVE RULES FOR ELECTING INVESTMENT PARTNERSHIPS.—

"(1) NO ADJUSTMENT OF PARTNERSHIP BASIS.—For purposes of this section, an electing investment partnership shall not be treated as having a substantial

built-in loss with respect to any transfer occurring while the election under paragraph (6)(A) is in effect.

"(2) LOSS DEFERRAL FOR TRANSFEREE PARTNER.—In the case of a transfer of an interest in an electing investment partnership, the transferee partner's distributive share of losses (without regard to gains) from the sale or exchange of partnership property shall not be allowed except to the extent that it is established that such losses exceed the loss (if any) recognized by the transferor (or any prior transferor to the extent not fully offset by a prior disallowance under this paragraph) on the transfer of the partnership interest.

"(3) NO REDUCTION IN PARTNERSHIP BASIS.—Losses disallowed under paragraph (2) shall not decrease the transferee partner's basis in the partnership interest.

"(4) EFFECT OF TERMINATION OF PARTNERSHIP.—This subsection shall be applied without regard to any termination of a partnership under section 708(b)(1)(B).

"(5) CERTAIN BASIS REDUCTIONS TREATED AS LOSSES.—In the case of a transferee partner whose basis in property distributed by the partnership is reduced under section 732(a)(2), the amount of the loss recognized by the transferor on the transfer of the partnership interest which is taken into account under paragraph (2) shall be reduced by the amount of such basis reduction.

"(6) ELECTING INVESTMENT PARTNERSHIP.—For purposes of this subsection, the term 'electing investment partnership' means any partnership if—

"(A) the partnership makes an election to have this subsection apply,

"(B) the partnership would be an investment company under section 3(a)(1)(A) of the Investment Company Act of 1940 but for an exemption under paragraph (1) or (7) of section 3(c) of such Act,

"(C) such partnership has never been engaged in a trade or business,

"(D) substantially all of the assets of such partnership are held for investment,

"(E) at least 95 percent of the assets contributed to such partnership consist of money,

"(F) no assets contributed to such partnership had an adjusted basis in excess of fair market value at the time of contribution,

"(G) all partnership interests of such partnership are issued by such partnership pursuant to a private offering and during the 24-month period beginning on the date of the first capital contribution to such partnership,

"(H) the partnership agreement of such partnership has substantive restrictions on each partner's ability to cause a redemption of the partner's interest, and

"(I) the partnership agreement of such partnership provides for a term that is not in excess of 15 years.

The election described in subparagraph (A), once made, shall be irrevocable except with the consent of the Secretary.

"(7) REGULATIONS.—The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this subsection, including regulations for applying this subsection to tiered partnerships.".

(B) INFORMATION REPORTING.—Section 6031 is amended by adding at the end the following new subsection:

"(f) ELECTING INVESTMENT PARTNERSHIPS.—In the case of any electing investment partnership (as defined in section 743(e)(6)), the information required under subsection (b) to be furnished to any partner to whom section 743(e)(2) applies shall include such information as is necessary to enable the partner to compute the amount of losses disallowed under section 743(e).".

(5) CLERICAL AMENDMENTS.—

(A) The section heading for section 743 is amended to read as follows:

**"SEC. 743. SPECIAL RULES WHERE SECTION 754 ELECTION OR SUBSTANTIAL BUILT-IN LOSS."**

(B) The table of sections for subpart C of part II of subchapter K of chapter 1 is amended by striking the item relating to section 743 and inserting the following new item:

"Sec. 743. Special rules where section 754 election or substantial built-in loss."

(c) ADJUSTMENT TO BASIS OF UNDISTRIBUTED PARTNERSHIP PROPERTY IF THERE IS SUBSTANTIAL BASIS REDUCTION.—

(1) ADJUSTMENT REQUIRED.—Subsection (a) of section 734 (relating to optional adjustment to basis of undistributed partnership property) is amended by inserting before the period "or unless there is a substantial basis reduction".

(2) ADJUSTMENT.—Subsection (b) of section 734 is amended by inserting "or unless there is a substantial basis reduction" after "section 754 is in effect".

(3) SUBSTANTIAL BASIS REDUCTION.—Section 734 is amended by adding at the end the following new subsection:

"(d) SUBSTANTIAL BASIS REDUCTION.—

"(1) IN GENERAL.—For purposes of this section, there is a substantial basis reduction with respect to a distribution if the sum of the amounts described in subparagraphs (A) and (B) of subsection (b)(2) exceeds $250,000.

"(2) REGULATIONS.—

**"For regulations to carry out this subsection, see section 743(d)(2)."**

(4) CLERICAL AMENDMENTS.—

(A) The section heading for section 734 is amended to read as follows:

**"SEC. 734. ADJUSTMENT TO BASIS OF UNDISTRIBUTED PARTNERSHIP PROPERTY WHERE SECTION 754 ELECTION OR SUBSTANTIAL BASIS REDUCTION."**

(B) The table of sections for subpart B of part II of subchapter K of chapter 1 is amended by striking the item relating to section 734 and inserting the following new item:

"Sec. 734. Adjustment to basis of undistributed partnership property where section 754 election or substantial basis reduction."

(d) EFFECTIVE DATES.—

(1) SUBSECTION (a).—The amendment made by subsection (a) shall apply to contributions made after the date of the enactment of this Act.

(2) SUBSECTION (b).—

(A) IN GENERAL.—Except as provided in subparagraph (B), the amendments made by subsection (b) shall apply to transfers after the date of the enactment of this Act.

(B) TRANSITION RULE.—In the case of an electing investment partnership which is in existence on June 4, 2004, section 743(e)(6)(H) of the Internal Revenue Code of 1986, as added by this section, shall not apply to such partnership and section 743(e)(6)(I) of such Code, as so added, shall be applied by substituting "20 years" for "15 years".

(3) SUBSECTION (c).—The amendments made by subsection (c) shall apply to distributions after the date of the enactment of this Act.

**SEC. 634. NO REDUCTION OF BASIS UNDER SECTION 734 IN STOCK HELD BY PARTNERSHIP IN CORPORATE PARTNER.**

(a) IN GENERAL.—Section 755 is amended by adding at the end the following new subsection:

"(c) NO ALLOCATION OF BASIS DECREASE TO STOCK OF CORPORATE PARTNER.—In making an allocation under subsection (a) of any decrease in the adjusted basis of partnership property under section 734(b)—

"(1) no allocation may be made to stock in a corporation (or any person related (within the meaning of sections 267(b) and 707(b)(1)) to such corporation) which is a partner in the partnership, and

"(2) any amount not allocable to stock by reason of paragraph (1) shall be allocated under subsection (a) to other partnership property.

Gain shall be recognized to the partnership to the extent that the amount required to be allocated under paragraph (2) to other partnership property exceeds the aggregate adjusted basis of such other property immediately before the allocation required by paragraph (2)."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to distributions after the date of the enactment of this Act.

**SEC. 635. REPEAL OF SPECIAL RULES FOR FASITS.**

(a) IN GENERAL.—Part V of subchapter M of chapter 1 (relating to financial asset securitization investment trusts) is hereby repealed.

(b) CONFORMING AMENDMENTS.—

(1) Paragraph (6) of section 56(g) is amended by striking "REMIC, or FASIT" and inserting "or REMIC".

(2) Clause (ii) of section 382(l)(4)(B) is amended by striking "a REMIC to which part IV of subchapter M applies, or a FASIT to which part V of subchapter M applies," and inserting "or a REMIC to which part IV of subchapter M applies,".

(3) Paragraph (1) of section 582(c) is amended by striking ", and any regular interest in a FASIT,".

(4) Subparagraph (E) of section 856(c)(5) is amended by striking the last sentence.

(5)(A) Section 860G(a)(1) is amended by adding at the end the following new sentence: "An interest shall not fail to qualify as a regular interest solely because the specified principal amount of the regular interest (or the amount of

interest accrued on the regular interest) can be reduced as a result of the nonoccurrence of 1 or more contingent payments with respect to any reverse mortgage loan held by the REMIC if, on the startup day for the REMIC, the sponsor reasonably believes that all principal and interest due under the regular interest will be paid at or prior to the liquidation of the REMIC.".

(B) The last sentence of section 860G(a)(3) is amended by inserting ", and any reverse mortgage loan (and each balance increase on such loan meeting the requirements of subparagraph (A)(iii)) shall be treated as an obligation secured by an interest in real property" before the period at the end.

(6) Paragraph (3) of section 860G(a) is amended by adding "and" at the end of subparagraph (B), by striking ", and" at the end of subparagraph (C) and inserting a period, and by striking subparagraph (D).

(7) Section 860G(a)(3), as amended by paragraph (6), is amended by adding at the end the following new sentence: "For purposes of subparagraph (A), if more than 50 percent of the obligations transferred to, or purchased by, the REMIC are originated by the United States or any State (or any political subdivision, agency, or instrumentality of the United States or any State) and are principally secured by an interest in real property, then each obligation transferred to, or purchased by, the REMIC shall be treated as secured by an interest in real property.".

(8)(A) Section 860G(a)(3)(A) is amended by striking "or" at the end of clause (i), by inserting "or" at the end of clause (ii), and by inserting after clause (ii) the following new clause:

"(iii) represents an increase in the principal amount under the original terms of an obligation described in clause (i) or (ii) if such increase—

"(I) is attributable to an advance made to the obligor pursuant to the original terms of the obligation,

"(II) occurs after the startup day, and

"(III) is purchased by the REMIC pursuant to a fixed price contract in effect on the startup day.".

(B) Section 860G(a)(7)(B) is amended to read as follows:

"(B) QUALIFIED RESERVE FUND.—For purposes of subparagraph (A), the term 'qualified reserve fund' means any reasonably required reserve to—

"(i) provide for full payment of expenses of the REMIC or amounts due on regular interests in the event of defaults on qualified mortgages or lower than expected returns on cash flow investments, or

"(ii) provide a source of funds for the purchase of obligations described in clause (ii) or (iii) of paragraph (3)(A).

The aggregate fair market value of the assets held in any such reserve shall not exceed 50 percent of the aggregate fair market value of all of the assets of the REMIC on the startup day, and the amount of any such reserve shall be promptly and appropriately reduced to the extent the amount held in such reserve is no longer reasonably required for purposes specified in clause (i) or (ii) of this subparagraph.".

(9) Subparagraph (C) of section 1202(e)(4) is amended by striking "REMIC, or FASIT" and inserting "or REMIC".

(10) Clause (xi) of section 7701(a)(19)(C) is amended—

(A) by striking "and any regular interest in a FASIT,", and

(B) by striking "or FASIT" each place it appears.

(11) Subparagraph (A) of section 7701(i)(2) is amended by striking "or a FASIT".

(12) The table of parts for subchapter M of chapter 1 is amended by striking the item relating to part V.

(c) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall take effect on January 1, 2005.

(2) EXCEPTION FOR EXISTING FASITS.—Paragraph (1) shall not apply to any FASIT in existence on the date of the enactment of this Act to the extent that regular interests issued by the FASIT before such date continue to remain outstanding in accordance with the original terms of issuance.

**SEC. 636. LIMITATION ON TRANSFER OF BUILT-IN LOSSES ON REMIC RESIDUALS.**

(a) IN GENERAL.—Section 362 (relating to basis to corporations) is amended by adding at the end the following new subsection:

"(e) LIMITATION ON TRANSFER OF BUILT-IN LOSSES ON REMIC RESIDUALS IN SECTION 351 TRANSACTIONS.—If—

"(1) a residual interest (as defined in section 860G(a)(2)) in a REMIC is transferred in any transaction which is described in subsection (a), and

"(2) the transferee's adjusted basis in such residual interest would (but for this paragraph) exceed its fair market value immediately after such transaction, then, notwithstanding subsection (a), the transferee's adjusted basis in such residual interest shall not exceed its fair market value (whether or not greater than zero) immediately after such transaction."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to transactions after the date of the enactment of this Act.

**SEC. 637. CLARIFICATION OF BANKING BUSINESS FOR PURPOSES OF DETERMINING INVESTMENT OF EARNINGS IN UNITED STATES PROPERTY.**

(a) IN GENERAL.—Subparagraph (A) of section 956(c)(2) is amended to read as follows:

"(A) obligations of the United States, money, or deposits with persons described in paragraph (4);".

(b) ELIGIBLE PERSONS.—Section 956(c) (relating to exceptions to definition of United States property) is amended by adding at the end the following new paragraph:

"(4) FINANCIAL SERVICES PROVIDERS.—

"(A) IN GENERAL.—For purposes of paragraph (2)(A), a person is described in this paragraph if at least 80 percent of the person's income is from the active conduct of a banking business which is derived from persons who are not related persons.

"(B) SPECIAL RULES.—For purposes of subparagraph (A) all related persons shall be treated as 1 person in applying the 80-percent test.

"(C) RELATED PERSON.—For purposes of this paragraph, a person is a related person to another person if—

"(i) the related person bears a relationship to such person specified in section 267(b) or 707(b)(1), or

"(ii) such persons are members of the same controlled group of corporations (as defined in section 1563(a), except that 'more than 50 percent' shall be substituted for 'at least 80 percent' each place it appears therein).".

(b) EFFECTIVE DATE.—The amendment made by this section shall take effect on the date of the enactment of this Act.

**SEC. 638. ALTERNATIVE TAX FOR CERTAIN SMALL INSURANCE COMPANIES.**

(a) IN GENERAL.—Clause (i) of section 831(b)(2)(A) is amended by striking "$1,200,000" and inserting "$1,890,000".

(b) INFLATION ADJUSTMENT.—Paragraph (2) of section 831(b) is amended by adding at the end the following new subparagraph:

"(C) INFLATION ADJUSTMENT.—In the case of any taxable year beginning in a calendar year after 2004, the $1,890,000 amount in subparagraph (A) shall be increased by an amount equal to—

"(i) $1,890,000, multiplied by

"(ii) the cost-of-living adjustment determined under section 1(f)(3) for such calendar year by substituting 'calendar year 2003' for 'calendar year 1992' in subparagraph (B) thereof.

If the amount as adjusted under the preceding sentence is not a multiple of $1,000, such amount shall be rounded to the next lowest multiple of $1,000.".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2003.

**SEC. 639. DENIAL OF DEDUCTION FOR INTEREST ON UNDERPAYMENTS ATTRIBUTABLE TO NONDISCLOSED REPORTABLE TRANSACTIONS.**

(a) IN GENERAL.—Section 163 (relating to deduction for interest) is amended by redesignating subsection (m) as subsection (n) and by inserting after subsection (l) the following new subsection:

"(m) INTEREST ON UNPAID TAXES ATTRIBUTABLE TO NONDISCLOSED REPORTABLE TRANSACTIONS.—No deduction shall be allowed under this chapter for any interest paid or accrued under section 6601 on any underpayment of tax which is attributable to the portion of any reportable transaction understatement (as defined in section 6662A(b)) with respect to which the requirement of section 6664(d)(2)(A) is not met.".

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to transactions in taxable years beginning after the date of the enactment of this Act.

**SEC. 640. CLARIFICATION OF RULES FOR PAYMENT OF ESTIMATED TAX FOR CERTAIN DEEMED ASSET SALES.**

(a) IN GENERAL.—Paragraph (13) of section 338(h) (relating to tax on deemed sale not taken into account for estimated tax purposes) is amended by adding at the end

the following: "The preceding sentence shall not apply with respect to a qualified stock purchase for which an election is made under paragraph (10).".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to transactions occurring after the date of the enactment of this Act.

**SEC. 641. RECOGNITION OF GAIN FROM THE SALE OF A PRINCIPAL RESIDENCE ACQUIRED IN A LIKE-KIND EXCHANGE WITHIN 5 YEARS OF SALE.**

(a) IN GENERAL.—Section 121(d) (relating to special rules for exclusion of gain from sale of principal residence) is amended by adding at the end the following new paragraph:

"(10) PROPERTY ACQUIRED IN LIKE-KIND EXCHANGE.—If a taxpayer acquired property in an exchange to which section 1031 applied, subsection (a) shall not apply to the sale or exchange of such property if it occurs during the 5-year period beginning with the date of the acquisition of such property.".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to sales or exchanges after the date of the enactment of this Act.

**SEC. 642. PREVENTION OF MISMATCHING OF INTEREST AND ORIGINAL ISSUE DISCOUNT DEDUCTIONS AND INCOME INCLUSIONS IN TRANSACTIONS WITH RELATED FOREIGN PERSONS.**

(a) ORIGINAL ISSUE DISCOUNT.—Section 163(e)(3) (relating to special rule for original issue discount on obligation held by related foreign person) is amended by redesignating subparagraph (B) as subparagraph (C) and by inserting after subparagraph (A) the following new subparagraph:

"(B) SPECIAL RULE FOR CERTAIN FOREIGN ENTITIES.—

"(i) IN GENERAL.—In the case of any debt instrument having original issue discount which is held by a related foreign person which is a foreign personal holding company (as defined in section 552), a controlled foreign corporation (as defined in section 957), or a passive foreign investment company (as defined in section 1297), a deduction shall be allowable to the issuer with respect to such original issue discount for any taxable year before the taxable year in which paid only to the extent such original issue discount (reduced by properly allowable deductions and qualified deficits under section 952(c)(1)(B)) is includible during such prior taxable year in the gross income of a United States person who owns (within the meaning of section 958(a)) stock in such corporation.

"(ii) SECRETARIAL AUTHORITY.—The Secretary may by regulation exempt transactions from the application of clause (i), including any transaction which is entered into by a payor in the ordinary course of a trade or business in which the payor is predominantly engaged.".

(b) INTEREST AND OTHER DEDUCTIBLE AMOUNTS.—Section 267(a)(3) is amended—

(1) by striking "The Secretary" and inserting:

"(A) IN GENERAL.—The Secretary", and

(2) by adding at the end the following new subparagraph:

"(B) SPECIAL RULE FOR CERTAIN FOREIGN ENTITIES.—

"(i) IN GENERAL.—Notwithstanding subparagraph (A), in the case of any item payable to a foreign personal holding company (as defined in section 552), a controlled foreign corporation (as defined in section 957), or a passive foreign investment company (as defined in section 1297), a deduction shall be allowable to the payor with respect to such amount for any taxable year before the taxable year in which paid only to the extent that an amount attributable to such item (reduced by properly allowable deductions and qualified deficits under section 952(c)(1)(B)) is includible during such prior taxable year in the gross income of a United States person who owns (within the meaning of section 958(a)) stock in such corporation.

"(ii) SECRETARIAL AUTHORITY.—The Secretary may by regulation exempt transactions from the application of clause (i), including any transaction which is entered into by a payor in the ordinary course of a trade or business in which the payor is predominantly engaged and in which the payment of the accrued amounts occurs within 8½ months after accrual or within such other period as the Secretary may prescribe.".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to payments accrued on or after the date of the enactment of this Act.

**SEC. 643. EXCLUSION FROM GROSS INCOME FOR INTEREST ON OVERPAYMENTS OF INCOME TAX BY INDIVIDUALS.**

(a) IN GENERAL.—Part III of subchapter B of chapter 1 (relating to items specifically excluded from gross income) is amended by inserting after section 139A the following new section:

**"SEC. 139B. EXCLUSION FROM GROSS INCOME FOR INTEREST ON OVERPAYMENTS OF INCOME TAX BY INDIVIDUALS.**

"(a) IN GENERAL.—In the case of an individual, gross income shall not include interest paid under section 6611 on any overpayment of tax imposed by this subtitle.

"(b) EXCEPTION.—Subsection (a) shall not apply in the case of a failure to claim items resulting in the overpayment on the original return if the Secretary determines that the principal purpose of such failure is to take advantage of subsection (a).

"(c) SPECIAL RULE FOR DETERMINING MODIFIED ADJUSTED GROSS INCOME.—For purposes of this title, interest not included in gross income under subsection (a) shall not be treated as interest which is exempt from tax for purposes of sections 32(i)(2)(B) and 6012(d) or any computation in which interest exempt from tax under this title is added to adjusted gross income.".

(b) CLERICAL AMENDMENT.—The table of sections for part III of subchapter B of chapter 1 is amended by inserting after the item relating to section 139A the following new item:

"Sec. 139B. Exclusion from gross income for interest on overpayments of income tax by individuals.".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to interest received in calendar years beginning after the date of the enactment of this Act.

**SEC. 644. DEPOSITS MADE TO SUSPEND RUNNING OF INTEREST ON POTENTIAL UNDERPAYMENTS.**

(a) IN GENERAL.—Subchapter A of chapter 67 (relating to interest on underpayments) is amended by adding at the end the following new section:

**"SEC. 6603. DEPOSITS MADE TO SUSPEND RUNNING OF INTEREST ON POTENTIAL UNDERPAYMENTS, ETC.**

"(a) AUTHORITY TO MAKE DEPOSITS OTHER THAN AS PAYMENT OF TAX.—A taxpayer may make a cash deposit with the Secretary which may be used by the Secretary to pay any tax imposed under subtitle A or B or chapter 41, 42, 43, or 44 which has not been assessed at the time of the deposit. Such a deposit shall be made in such manner as the Secretary shall prescribe.

"(b) NO INTEREST IMPOSED.—To the extent that such deposit is used by the Secretary to pay tax, for purposes of section 6601 (relating to interest on underpayments), the tax shall be treated as paid when the deposit is made.

"(c) RETURN OF DEPOSIT.—Except in a case where the Secretary determines that collection of tax is in jeopardy, the Secretary shall return to the taxpayer any amount of the deposit (to the extent not used for a payment of tax) which the taxpayer requests in writing.

"(d) PAYMENT OF INTEREST.—

"(1) IN GENERAL.—For purposes of section 6611 (relating to interest on overpayments), a deposit which is returned to a taxpayer shall be treated as a payment of tax for any period to the extent (and only to the extent) attributable to a disputable tax for such period. Under regulations prescribed by the Secretary, rules similar to the rules of section 6611(b)(2) shall apply.

"(2) DISPUTABLE TAX.—

"(A) IN GENERAL.—For purposes of this section, the term 'disputable tax' means the amount of tax specified at the time of the deposit as the taxpayer's reasonable estimate of the maximum amount of any tax attributable to disputable items.

"(B) SAFE HARBOR BASED ON 30-DAY LETTER.—In the case of a taxpayer who has been issued a 30-day letter, the maximum amount of tax under subparagraph (A) shall not be less than the amount of the proposed deficiency specified in such letter.

"(3) OTHER DEFINITIONS.—For purposes of paragraph (2)—

"(A) DISPUTABLE ITEM.—The term 'disputable item' means any item of income, gain, loss, deduction, or credit if the taxpayer—

"(i) has a reasonable basis for its treatment of such item, and

"(ii) reasonably believes that the Secretary also has a reasonable basis for disallowing the taxpayer's treatment of such item.

"(B) 30-DAY LETTER.—The term '30-day letter' means the first letter of proposed deficiency which allows the taxpayer an opportunity for administrative review in the Internal Revenue Service Office of Appeals.

"(4) RATE OF INTEREST.—The rate of interest allowable under this subsection shall be the Federal short-term rate determined under section 6621(b), compounded daily.

"(e) USE OF DEPOSITS.—

"(1) PAYMENT OF TAX.—Except as otherwise provided by the taxpayer, deposits shall be treated as used for the payment of tax in the order deposited.

"(2) RETURNS OF DEPOSITS.—Deposits shall be treated as returned to the taxpayer on a last-in, first-out basis.".

(b) CLERICAL AMENDMENT.—The table of sections for subchapter A of chapter 67 is amended by adding at the end the following new item:

"Sec. 6603. Deposits made to suspend running of interest on potential underpayments, etc.".

(c) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendments made by this section shall apply to deposits made after the date of the enactment of this Act.

(2) COORDINATION WITH DEPOSITS MADE UNDER REVENUE PROCEDURE 84–58.—In the case of an amount held by the Secretary of the Treasury or his delegate on the date of the enactment of this Act as a deposit in the nature of a cash bond deposit pursuant to Revenue Procedure 84–58, the date that the taxpayer identifies such amount as a deposit made pursuant to section 6603 of the Internal Revenue Code (as added by this Act) shall be treated as the date such amount is deposited for purposes of such section 6603.

**SEC. 645. PARTIAL PAYMENT OF TAX LIABILITY IN INSTALLMENT AGREEMENTS.**

(a) IN GENERAL.—

(1) Section 6159(a) (relating to authorization of agreements) is amended—

(A) by striking "satisfy liability for payment of" and inserting "make payment on", and

(B) by inserting "full or partial" after "facilitate".

(2) Section 6159(c) (relating to Secretary required to enter into installment agreements in certain cases) is amended in the matter preceding paragraph (1) by inserting "full" before "payment".

(b) REQUIREMENT TO REVIEW PARTIAL PAYMENT AGREEMENTS EVERY TWO YEARS.—Section 6159 is amended by redesignating subsections (d) and (e) as subsections (e) and (f), respectively, and inserting after subsection (c) the following new subsection:

"(d) SECRETARY REQUIRED TO REVIEW INSTALLMENT AGREEMENTS FOR PARTIAL COLLECTION EVERY TWO YEARS.—In the case of an agreement entered into by the Secretary under subsection (a) for partial collection of a tax liability, the Secretary shall review the agreement at least once every 2 years.".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to agreements entered into on or after the date of the enactment of this Act.

**SEC. 646. AFFIRMATION OF CONSOLIDATED RETURN REGULATION AUTHORITY.**

(a) IN GENERAL.—Section 1502 is amended by adding at the end the following new sentence: "In carrying out the preceding sentence, the Secretary may prescribe rules that are different from the provisions of chapter 1 that would apply if such corporations filed separate returns.".

(b) RESULT NOT OVERTURNED.—Notwithstanding the amendment made by subsection (a), the Internal Revenue Code of 1986 shall be construed by treating Treasury Regulation § 1.1502-20(c)(1)(iii) (as in effect on January 1, 2001) as being inapplicable to the factual situation in *Rite Aid Corporation and Subsidiary Corporations v. United States*, 255 F.3d 1357 (Fed. Cir. 2001).

(c) EFFECTIVE DATE.—This section, and the amendment made by this section, shall apply to taxable years beginning before, on, or after the date of the enactment of this Act.

## Part III—Leasing

**SEC. 647. REFORM OF TAX TREATMENT OF CERTAIN LEASING ARRANGEMENTS.**

(a) CLARIFICATION OF RECOVERY PERIOD FOR TAX-EXEMPT USE PROPERTY SUBJECT TO LEASE.—Subparagraph (A) of section 168(g)(3) (relating to special rules for determining class life) is amended by inserting "(notwithstanding any other subparagraph of this paragraph)" after "shall".

(b) LIMITATION ON DEPRECIATION PERIOD FOR SOFTWARE LEASED TO TAX-EXEMPT ENTITY.—Paragraph (1) of section 167(f) is amended by adding at the end the following new subparagraph:

"(C) TAX-EXEMPT USE PROPERTY SUBJECT TO LEASE.—In the case of computer software which would be tax-exempt use property as defined in subsection (h) of section 168 if such section applied to computer software, the useful life under subparagraph (A) shall not be less than 125 percent of the lease term (within the meaning of section 168(i)(3)).".

(c) LEASE TERM TO INCLUDE RELATED SERVICE CONTRACTS.—Subparagraph (A) of section 168(i)(3) (relating to lease term) is amended by striking "and" at the end of clause (i), by redesignating clause (ii) as clause (iii), and by inserting after clause (i) the following new clause:

"(ii) the term of a lease shall include the term of any service contract or similar arrangement (whether or not treated as a lease under section 7701(e))—

"(I) which is part of the same transaction (or series of related transactions) which includes the lease, and

"(II) which is with respect to the property subject to the lease or substantially similar property, and".

(d) EXPANSION OF SHORT-TERM LEASE EXEMPTION FOR QUALIFIED TECHNOLOGICAL EQUIPMENT.—Subparagraph (A) of section 168(h)(3) is amended by adding at the end the following new sentence: "Notwithstanding subsection (i)(3)(A)(i), in determining a lease term for purposes of the preceding sentence, there shall not be taken into account any option of the lessee to renew at the fair market value rent determined at the time of renewal; except that the aggregate period not taken into account by reason of this sentence shall not exceed 24 months."

**SEC. 648. LIMITATION ON DEDUCTIONS ALLOCABLE TO PROPERTY USED BY GOVERNMENTS OR OTHER TAX-EXEMPT ENTITIES.**

(a) IN GENERAL.—Subpart C of part II of subchapter E of chapter 1 (relating to taxable year for which deductions taken) is amended by adding at the end the following new section:

**"SEC. 470. LIMITATION ON DEDUCTIONS ALLOCABLE TO PROPERTY USED BY GOVERNMENTS OR OTHER TAX-EXEMPT ENTITIES.**

"(a) LIMITATION ON LOSSES.—Except as otherwise provided in this section, a tax-exempt use loss for any taxable year shall not be allowed.

"(b) DISALLOWED LOSS CARRIED TO NEXT YEAR.—Any tax-exempt use loss with respect to any tax-exempt use property which is disallowed under subsection (a) for any taxable year shall be treated as a deduction with respect to such property in the next taxable year.

"(c) DEFINITIONS.—For purposes of this section—

"(1) TAX-EXEMPT USE LOSS.—The term 'tax-exempt use loss' means, with respect to any taxable year, the amount (if any) by which—

"(A) the sum of—

"(i) the aggregate deductions (other than interest) directly allocable to a tax-exempt use property, plus

"(ii) the aggregate deductions for interest properly allocable to such property, exceed

"(B) the aggregate income from such property.

"(2) TAX-EXEMPT USE PROPERTY.—The term 'tax-exempt use property' has the meaning given to such term by section 168(h) (without regard to paragraphs (1)(C) and (3) thereof and determined as if property described in section 167(f)(1)(B) were tangible property). Such term shall not include property which would (but for this sentence) be tax-exempt use property solely by reason of section 168(h)(6) if any credit is allowable under section 42 or 47 with respect to such property.

"(d) EXCEPTION FOR CERTAIN LEASES.—This section shall not apply to any lease of property which meets the requirements of all of the following paragraphs:

"(1) AVAILABILITY OF FUNDS.—

"(A) IN GENERAL.—A lease of property meets the requirements of this paragraph if (at any time during the lease term) not more than an allowable amount of funds are—

"(i) subject to any arrangement referred to in subparagraph (B), or

"(ii) set aside or expected to be set aside,

to or for the benefit of the lessor or any lender, or to or for the benefit of the lessee to satisfy the lessee's obligations or options under the lease. For purposes of clause (ii), funds shall be treated as set aside or expected to be set aside only if a reasonable person would conclude, based on the facts and circumstances, that such funds are set aside or expected to be set aside.

"(B) ARRANGEMENTS.—The arrangements referred to in this subparagraph include a defeasance arrangement, a loan by the lessee to the lessor or any lender, a deposit arrangement, a letter of credit collateralized with

cash or cash equivalents, a payment undertaking agreement, prepaid rent (within the meaning of the regulations under section 467), a sinking fund arrangement, a guaranteed investment contract, financial guaranty insurance, and any similar arrangement (whether or not such arrangement provides credit support).

"(C) ALLOWABLE AMOUNT.—

"(i) IN GENERAL.—Except as otherwise provided in this subparagraph, the term 'allowable amount' means an amount equal to 20 percent of the lessor's adjusted basis in the property at the time the lease is entered into.

"(ii) HIGHER AMOUNT PERMITTED IN CERTAIN CASES.—To the extent provided in regulations, a higher percentage shall be permitted under clause (i) where necessary because of the credit-worthiness of the lessee. In no event may such regulations permit a percentage of more than 50 percent.

"(iii) OPTION TO PURCHASE OTHER THAN AT FAIR MARKET VALUE.—If under the lease the lessee has the option to purchase the property for a fixed price or for other than the fair market value of the property (determined at the time of exercise), the allowable amount at the time such option may be exercised may not exceed 50 percent of the price at which such option may be exercised.

"(iv) NO ALLOWABLE AMOUNT FOR CERTAIN ARRANGEMENTS.—The allowable amount shall be zero with respect to any arrangement which involves—

"(I) a loan from the lessee to the lessor or a lender,

"(II) any deposit received, letter of credit issued, or payment undertaking agreement entered into by a lender otherwise involved in the transaction, or

"(III) in the case of a transaction which involves a lender, any credit support made available to the lessor in which any such lender does not have a claim that is senior to the lessor.

For purposes of subclause (I), the term 'loan' shall not include any amount treated as a loan under section 467 with respect to a section 467 rental agreement.

"(2) LESSOR MUST MAKE SUBSTANTIAL EQUITY INVESTMENT.—

"(A) IN GENERAL.—A lease of property meets the requirements of this paragraph if—

"(i) the lessor—

"(I) has at the time the lease is entered into an unconditional at-risk equity investment (as determined by the Secretary) in the property of at least 20 percent of the lessor's adjusted basis in the property as of that time, and

"(II) maintains such investment throughout the term of the lease, and

"(ii) the fair market value of the property at the end of the lease term is reasonably expected to be equal to at least 20 percent of such basis.

"(B) RISK OF LOSS.—For purposes of clause (ii), the fair market value at the end of the lease term shall be reduced to the extent that a person other than the lessor bears a risk of loss in the value of the property.

"(C) PARAGRAPH NOT TO APPLY TO SHORT-TERM LEASES.—This paragraph shall not apply to any lease with a lease term of 5 years or less.

"(3) LESSEE MAY NOT BEAR MORE THAN MINIMAL RISK OF LOSS.—

"(A) IN GENERAL.—A lease of property meets the requirements of this paragraph if there is no arrangement under which the lessee bears—

"(i) any portion of the loss that would occur if the fair market value of the leased property were 25 percent less than its reasonably expected fair market value at the time the lease is terminated, or

"(ii) more than 50 percent of the loss that would occur if the fair market value of the leased property at the time the lease is terminated were zero.

"(B) EXCEPTION.—The Secretary may by regulations provide that the requirements of this paragraph are not met where the lessee bears more than a minimal risk of loss.

"(C) PARAGRAPH NOT TO APPLY TO SHORT-TERM LEASES.—This paragraph shall not apply to any lease with a lease term of 5 years or less.

"(e) SPECIAL RULES.—

"(1) TREATMENT OF FORMER TAX-EXEMPT USE PROPERTY.—

"(A) IN GENERAL.—In the case of any former tax-exempt use property—

"(i) any deduction allowable under subsection (b) with respect to such property for any taxable year shall be allowed only to the extent of any net income (without regard to such deduction) from such property for such taxable year, and

"(ii) any portion of such unused deduction remaining after application of clause (i) shall be treated as a deduction allowable under subsection (b) with respect to such property in the next taxable year.

"(B) FORMER TAX-EXEMPT USE PROPERTY.—For purposes of this subsection, the term 'former tax-exempt use property' means any property which—

"(i) is not tax-exempt use property for the taxable year, but

"(ii) was tax-exempt use property for any prior taxable year.

"(2) DISPOSITION OF ENTIRE INTEREST IN PROPERTY.—If during the taxable year a taxpayer disposes of the taxpayer's entire interest in tax-exempt use property (or former tax-exempt use property), rules similar to the rules of section 469(g) shall apply for purposes of this section.

"(3) COORDINATION WITH SECTION 469.—This section shall be applied before the application of section 469.

"(4) COORDINATION WITH SECTIONS 1031 AND 1033.—

"(A) IN GENERAL.—Sections 1031(a) and 1033(a) shall not apply if—

"(i) the exchanged or converted property is tax-exempt use property subject to a lease which was entered into before March 13, 2004, and which would not have met the requirements of subsection (d) had such requirements been in effect when the lease was entered into, or

"(ii) the replacement property is tax-exempt use property subject to a lease which does not meet the requirements of subsection (d).

"(B) ADJUSTED BASIS.—In the case of property acquired by the lessor in a transaction to which section 1031 or 1033 applies, the adjusted basis of such property for purposes of this section shall be equal to the lesser of—

"(i) the fair market value of the property as of the beginning of the lease term, or

"(ii) the amount which would be the lessor's adjusted basis if such sections did not apply to such transaction.

"(f) OTHER DEFINITIONS.—For purposes of this section—

"(1) RELATED PARTIES.—The terms 'lessor', 'lessee', and 'lender' each include any related party (within the meaning of section 197(f)(9)(C)(i)).

"(2) LEASE TERM.—The term 'lease term' has the meaning given to such term by section 168(i)(3).

"(3) LENDER.—The term 'lender' means, with respect to any lease, a person that makes a loan to the lessor which is secured (or economically similar to being secured) by the lease or the leased property.

"(4) LOAN.—The term 'loan' includes any similar arrangement.

"(g) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the provisions of this section, including regulations which—

"(1) allow in appropriate cases the aggregation of property subject to the same lease, and

"(2) provide for the determination of the allocation of interest expense for purposes of this section.".

(b) CONFORMING AMENDMENT.—The table of sections for subpart C of part II of subchapter E of chapter 1 is amended by adding at the end the following new item:

"Sec. 470. Limitation on deductions allocable to property used by governments or other tax-exempt entities.".

**SEC. 649. EFFECTIVE DATE.**

(a) IN GENERAL.—Except as provided in this section, the amendments made by this part shall apply to leases entered into after March 12, 2004.

(b) EXCEPTION.—

(1) IN GENERAL.—The amendments made by this part shall not apply to qualified transportation property.

(2) QUALIFIED TRANSPORTATION PROPERTY.—For purposes of paragraph (1), the term "qualified transportation property" means domestic property subject to a lease with respect to which a formal application—

(A) was submitted for approval to the Federal Transit Administration (an agency of the Department of Transportation) after June 30, 2003, and before March 13, 2004,

(B) is approved by the Federal Transit Administration before January 1, 2005, and

(C) includes a description of such property and the value of such property.

(3) EXCHANGES AND CONVERSION OF TAX-EXEMPT USE PROPERTY.—Section 470(e)(4) of the Internal Revenue Code of 1986, as added by this section, shall apply to property exchanged or converted after the date of the enactment of this Act.

# Subtitle C—Reduction of Fuel Tax Evasion

**SEC. 651. EXEMPTION FROM CERTAIN EXCISE TAXES FOR MOBILE MACHINERY.**

(a) EXEMPTION FROM TAX ON HEAVY TRUCKS AND TRAILERS SOLD AT RETAIL.—

(1) IN GENERAL.—Section 4053 (relating to exemptions) is amended by adding at the end the following new paragraph:

"(8) MOBILE MACHINERY.—Any vehicle which consists of a chassis—

"(A) to which there has been permanently mounted (by welding, bolting, riveting, or other means) machinery or equipment to perform a construction, manufacturing, processing, farming, mining, drilling, timbering, or similar operation if the operation of the machinery or equipment is unrelated to transportation on or off the public highways,

"(B) which has been specially designed to serve only as a mobile carriage and mount (and a power source, where applicable) for the particular machinery or equipment involved, whether or not such machinery or equipment is in operation, and

"(C) which, by reason of such special design, could not, without substantial structural modification, be used as a component of a vehicle designed to perform a function of transporting any load other than that particular machinery or equipment or similar machinery or equipment requiring such a specially designed chassis.".

(2) EFFECTIVE DATE.—The amendment made by this subsection shall take effect on the day after the date of the enactment of this Act.

(b) EXEMPTION FROM TAX ON USE OF CERTAIN VEHICLES.—

(1) IN GENERAL.—Section 4483 (relating to exemptions) is amended by redesignating subsection (g) as subsection (h) and by inserting after subsection (f) the following new subsection:

"(g) EXEMPTION FOR MOBILE MACHINERY.—No tax shall be imposed by section 4481 on the use of any vehicle described in section 4053(8).".

(2) EFFECTIVE DATE.—The amendments made by this subsection shall take effect on the day after the date of the enactment of this Act.

(c) EXEMPTION FROM TAX ON TIRES.—

(1) IN GENERAL.—Section 4072(b)(2) is amended by adding at the end the following flush sentence: "Such term shall not include tires of a type used exclusively on vehicles described in section 4053(8).".

(2) EFFECTIVE DATE.—The amendment made by this subsection shall take effect on the day after the date of the enactment of this Act.

(d) REFUND OF FUEL TAXES.—

(1) IN GENERAL.—Section 6421(e)(2) (defining off-highway business use) is amended by adding at the end the following new subparagraph:

"(C) USES IN MOBILE MACHINERY.—

"(i) IN GENERAL.—The term 'off-highway business use' shall include any use in a vehicle which meets the requirements described in clause (ii).

"(ii) REQUIREMENTS FOR MOBILE MACHINERY.—The requirements described in this clause are—

"(I) the design-based test, and

"(II) the use-based test.

"(iii) DESIGN-BASED TEST.—For purposes of clause (ii)(I), the design-based test is met if the vehicle consists of a chassis—

"(I) to which there has been permanently mounted (by welding, bolting, riveting, or other means) machinery or equipment to perform a construction, manufacturing, processing, farming, mining, drilling, timbering, or similar operation if the operation of the machinery or equipment is unrelated to transportation on or off the public highways,

"(II) which has been specially designed to serve only as a mobile carriage and mount (and a power source, where applicable) for the particular machinery or equipment involved, whether or not such machinery or equipment is in operation, and

"(III) which, by reason of such special design, could not, without substantial structural modification, be used as a component of a vehicle designed to perform a function of transporting any load

other than that particular machinery or equipment or similar machinery or equipment requiring such a specially designed chassis.

"(iv) USE-BASED TEST.—For purposes of clause (ii)(II), the use-based test is met if the use of the vehicle on public highways was less than 7,500 miles during the taxpayer's taxable year.".

(2) NO TAX-FREE SALES.—Subsection (b) of section 4082, as amended by section 652, is amended by inserting before the period at the end "and such term shall not include any use described in section 6421(e)(2)(C)".

(3) ANNUAL REFUND OF TAX PAID.—Section 6427(i)(2) (relating to exceptions) is amended by adding at the end the following new subparagraph:

"(C) NONAPPLICATION OF PARAGRAPH.—This paragraph shall not apply to any fuel used solely in any off-highway business use described in section 6421(e)(2)(C).".

(4) EFFECTIVE DATE.—The amendments made by this subsection shall apply to taxable years beginning after the date of the enactment of this Act.

**SEC. 652. TAXATION OF AVIATION-GRADE KEROSENE.**

(a) RATE OF TAX.—

(1) IN GENERAL.—Subparagraph (A) of section 4081(a)(2) is amended by striking "and" at the end of clause (ii), by striking the period at the end of clause (iii) and inserting ", and", and by adding at the end the following new clause:

"(iv) in the case of aviation-grade kerosene, 21.8 cents per gallon.".

(2) COMMERCIAL AVIATION.—Paragraph (2) of section 4081(a) is amended by adding at the end the following new subparagraph:

"(C) TAXES IMPOSED ON FUEL USED IN COMMERCIAL AVIATION.—In the case of aviation-grade kerosene which is removed from any refinery or terminal directly into the fuel tank of an aircraft for use in commercial aviation, the rate of tax under subparagraph (A)(iv) shall be 4.3 cents per gallon.".

(3) CERTAIN REFUELER TRUCKS, TANKERS, AND TANK WAGONS TREATED AS TERMINAL.—Subsection (a) of section 4081 is amended by adding at the end the following new paragraph:

"(3) CERTAIN REFUELER TRUCKS, TANKERS, AND TANK WAGONS TREATED AS TERMINAL.—

"(A) IN GENERAL.—In the case of aviation-grade kerosene which is removed from any terminal directly into the fuel tank of an aircraft (determined without regard to any refueler truck, tanker, or tank wagon which meets the requirements of subparagraph (B)), a refueler truck, tanker, or tank wagon shall be treated as part of such terminal if—

"(i) such truck, tanker, or wagon meets the requirements of subparagraph (B) with respect to an airport, and

"(ii) except in the case of exigent circumstances identified by the Secretary in regulations, no vehicle registered for highway use is loaded with aviation-grade kerosene at such terminal.

"(B) REQUIREMENTS.—A refueler truck, tanker, or tank wagon meets the requirements of this subparagraph with respect to an airport if such truck, tanker, or wagon—

"(i) is loaded with aviation-grade kerosene at such terminal located within such airport and delivers such kerosene only into aircraft at such airport,

"(ii) has storage tanks, hose, and coupling equipment designed and used for the purposes of fueling aircraft,

"(iii) is not registered for highway use, and

"(iv) is operated by—

"(I) the terminal operator of such terminal, or

"(II) a person that makes a daily accounting to such terminal operator of each delivery of fuel from such truck, tanker, or wagon.

"(C) REPORTING.—The Secretary shall require under section 4101(d) reporting by such terminal operator of—

"(i) any information obtained under subparagraph (B)(iv)(II), and

"(ii) any similar information maintained by such terminal operator with respect to deliveries of fuel made by trucks, tankers, or wagons operated by such terminal operator.".

(4) LIABILITY FOR TAX ON AVIATION-GRADE KEROSENE USED IN COMMERCIAL AVIATION.—Subsection (a) of section 4081 is amended by adding at the end the following new paragraph:

"(4) LIABILITY FOR TAX ON AVIATION-GRADE KEROSENE USED IN COMMERCIAL AVIATION.—For purposes of paragraph (2)(C), the person who uses the fuel for commercial aviation shall pay the tax imposed under such paragraph. For pur-

poses of the preceding sentence, fuel shall be treated as used when such fuel is removed into the fuel tank.".

(5) NONTAXABLE USES.—

(A) IN GENERAL.—Section 4082 is amended by redesignating subsections (e) and (f) as subsections (f) and (g), respectively, and by inserting after subsection (d) the following new subsection:

"(e) AVIATION-GRADE KEROSENE.—In the case of aviation-grade kerosene which is exempt from the tax imposed by section 4041(c) (other than by reason of a prior imposition of tax) and which is removed from any refinery or terminal directly into the fuel tank of an aircraft, the rate of tax under section 4081(a)(2)(A)(iv) shall be zero.".

(B) CONFORMING AMENDMENTS.—

(i) Subsection (b) of section 4082 is amended by adding at the end the following new flush sentence:

"The term 'nontaxable use' does not include the use of aviation-grade kerosene in an aircraft.".

(ii) Section 4082(d) is amended by striking paragraph (1) and by redesignating paragraphs (2) and (3) as paragraphs (1) and (2), respectively.

(6) NONAIRCRAFT USE OF AVIATION-GRADE KEROSENE.—

(A) IN GENERAL.—Subparagraph (B) of section 4041(a)(1) is amended by adding at the end the following new sentence: "This subparagraph shall not apply to aviation-grade kerosene.".

(B) CONFORMING AMENDMENT.—The heading for paragraph (1) of section 4041(a) is amended by inserting "AND KEROSENE" after "DIESEL FUEL".

(b) COMMERCIAL AVIATION.—Section 4083 is amended by redesignating subsections (b) and (c) as subsections (c) and (d), respectively, and by inserting after subsection (a) the following new subsection:

"(b) COMMERCIAL AVIATION.—For purposes of this subpart, the term 'commercial aviation' means any use of an aircraft in a business of transporting persons or property for compensation or hire by air, unless properly allocable to any transportation exempt from the taxes imposed by sections 4261 and 4271 by reason of section 4281 or 4282 or by reason of section 4261(h).".

(c) REFUNDS.—

(1) IN GENERAL.—Paragraph (4) of section 6427(l) is amended to read as follows:

"(4) REFUNDS FOR AVIATION-GRADE KEROSENE.—

"(A) NO REFUND OF CERTAIN TAXES ON FUEL USED IN COMMERCIAL AVIATION.—In the case of aviation-grade kerosene used in commercial aviation (as defined in section 4083(b)) (other than supplies for vessels or aircraft within the meaning of section 4221(d)(3)), paragraph (1) shall not apply to so much of the tax imposed by section 4081 as is attributable to—

"(i) the Leaking Underground Storage Tank Trust Fund financing rate imposed by such section, and

"(ii) so much of the rate of tax specified in section 4081(a)(2)(A)(iv) as does not exceed 4.3 cents per gallon.

"(B) PAYMENT TO ULTIMATE, REGISTERED VENDOR.—With respect to aviation-grade kerosene, if the ultimate purchaser of such kerosene waives (at such time and in such form and manner as the Secretary shall prescribe) the right to payment under paragraph (1) and assigns such right to the ultimate vendor, then the Secretary shall pay the amount which would be paid under paragraph (1) to such ultimate vendor, but only if such ultimate vendor—

"(i) is registered under section 4101, and

"(ii) meets the requirements of subparagraph (A), (B), or (D) of section 6416(a)(1).".

(2) TIME FOR FILING CLAIMS.—Subparagraph (A) of section 6427(i)(4) is amended—

(A) by striking "subsection (l)(5)" both places it appears and inserting "paragraph (4)(B) or (5) of subsection (l)", and

(B) by striking "the preceding sentence" and inserting "subsection (l)(5)".

(3) CONFORMING AMENDMENT.—Subparagraph (B) of section 6427(l)(2) is amended to read as follows:

"(B) in the case of aviation-grade kerosene—

"(i) any use which is exempt from the tax imposed by section 4041(c) other than by reason of a prior imposition of tax, or

"(ii) any use in commercial aviation (within the meaning of section 4083(b)).".

(d) REPEAL OF PRIOR TAXATION OF AVIATION FUEL.—

(1) IN GENERAL.—Part III of subchapter A of chapter 32 is amended by striking subpart B and by redesignating subpart C as subpart B.

(2) CONFORMING AMENDMENTS.—

(A) Section 4041(c) is amended to read as follows:

"(c) AVIATION-GRADE KEROSENE.—

"(1) IN GENERAL.—There is hereby imposed a tax upon aviation-grade kerosene—

"(A) sold by any person to an owner, lessee, or other operator of an aircraft for use in such aircraft, or

"(B) used by any person in an aircraft unless there was a taxable sale of such fuel under subparagraph (A).

"(2) EXEMPTION FOR PREVIOUSLY TAXED FUEL.—No tax shall be imposed by this subsection on the sale or use of any aviation-grade kerosene if tax was imposed on such liquid under section 4081 and the tax thereon was not credited or refunded.

"(3) RATE OF TAX.—The rate of tax imposed by this subsection shall be the rate of tax specified in section 4081(a)(2)(A)(iv) which is in effect at the time of such sale or use.".

(B) Section 4041(d)(2) is amended by striking "section 4091" and inserting "section 4081".

(C) Section 4041 is amended by striking subsection (e).

(D) Section 4041 is amended by striking subsection (i).

(E) Sections 4101(a), 4103, 4221(a), and 6206 are each amended by striking ", 4081, or 4091" and inserting "or 4081".

(F) Section 6416(b)(2) is amended by striking "4091 or".

(G) Section 6416(b)(3) is amended by striking "or 4091" each place it appears.

(H) Section 6416(d) is amended by striking "or to the tax imposed by section 4091 in the case of refunds described in section 4091(d)".

(I) Section 6427(j)(1) is amended by striking ", 4081, and 4091" and inserting "and 4081".

(J)(i) Section 6427(l)(1) is amended to read as follows:

"(1) IN GENERAL.—Except as otherwise provided in this subsection and in subsection (k), if any diesel fuel or kerosene on which tax has been imposed by section 4041 or 4081 is used by any person in a nontaxable use, the Secretary shall pay (without interest) to the ultimate purchaser of such fuel an amount equal to the aggregate amount of tax imposed on such fuel under section 4041 or 4081, as the case may be, reduced by any payment made to the ultimate vendor under paragraph (4)(B).".

(ii) Paragraph (5)(B) of section 6427(l) is amended by striking "Paragraph (1)(A) shall not apply to kerosene" and inserting "Paragraph (1) shall not apply to kerosene (other than aviation-grade kerosene)".

(K) Subparagraph (B) of section 6724(d)(1) is amended by striking clause (xv) and by redesignating the succeeding clauses accordingly.

(L) Paragraph (2) of section 6724(d) is amended by striking subparagraph (W) and by redesignating the succeeding subparagraphs accordingly.

(M) Paragraph (1) of section 9502(b) is amended by adding "and" at the end of subparagraph (B) and by striking subparagraphs (C) and (D) and inserting the following new subparagraph:

"(C) section 4081 with respect to aviation gasoline and aviation-grade kerosene, and".

(N) The last sentence of section 9502(b) is amended to read as follows: "There shall not be taken into account under paragraph (1) so much of the taxes imposed by section 4081 as are determined at the rate specified in section 4081(a)(2)(B).".

(O) Subsection (b) of section 9508 is amended by striking paragraph (3) and by redesignating paragraphs (4) and (5) as paragraphs (3) and (4), respectively.

(P) Section 9508(c)(2)(A) is amended by striking "sections 4081 and 4091" and inserting "section 4081".

(Q) The table of subparts for part III of subchapter A of chapter 32 is amended to read as follows:

"Subpart A. Motor and aviation fuels.
"Subpart B. Special provisions applicable to fuels tax.".

(R) The heading for subpart A of part III of subchapter A of chapter 32 is amended to read as follows:

## "Subpart A—Motor and Aviation Fuels".

(S) The heading for subpart B of part III of subchapter A of chapter 32, as redesignated by paragraph (1), is amended to read as follows:

## "Subpart B—Special Provisions Applicable to Fuels Tax".

(e) EFFECTIVE DATE.—The amendments made by this section shall apply to aviation-grade kerosene removed, entered, or sold after September 30, 2004.

(f) FLOOR STOCKS TAX.—

(1) IN GENERAL.—There is hereby imposed on aviation-grade kerosene held on October 1, 2004, by any person a tax equal to—

(A) the tax which would have been imposed before such date on such kerosene had the amendments made by this section been in effect at all times before such date, reduced by

(B) the tax imposed before such date under section 4091 of the Internal Revenue Code of 1986, as in effect on the day before the date of the enactment of this Act.

(2) LIABILITY FOR TAX AND METHOD OF PAYMENT.—

(A) LIABILITY FOR TAX.—The person holding the kerosene on October 1, 2004, to which the tax imposed by paragraph (1) applies shall be liable for such tax.

(B) METHOD AND TIME FOR PAYMENT.—The tax imposed by paragraph (1) shall be paid at such time and in such manner as the Secretary of the Treasury (or the Secretary's delegate) shall prescribe, including the non-application of such tax on de minimis amounts of kerosene.

(3) TRANSFER OF FLOOR STOCK TAX REVENUES TO TRUST FUNDS.—For purposes of determining the amount transferred to any trust fund, the tax imposed by this subsection shall be treated as imposed by section 4081 of the Internal Revenue Code of 1986—

(A) at the Leaking Underground Storage Tank Trust Fund financing rate under such section to the extent of 0.1 cents per gallon, and

(B) at the rate under section 4081(a)(2)(A)(iv) to the extent of the remainder.

(4) HELD BY A PERSON.—For purposes of this section, kerosene shall be considered as held by a person if title thereto has passed to such person (whether or not delivery to the person has been made).

(5) OTHER LAWS APPLICABLE.—All provisions of law, including penalties, applicable with respect to the tax imposed by section 4081 of such Code shall, insofar as applicable and not inconsistent with the provisions of this subsection, apply with respect to the floor stock tax imposed by paragraph (1) to the same extent as if such tax were imposed by such section.

**SEC. 653. DYE INJECTION EQUIPMENT.**

(a) IN GENERAL.—Section 4082(a)(2) (relating to exemptions for diesel fuel and kerosene) is amended by inserting "by mechanical injection" after "indelibly dyed".

(b) DYE INJECTOR SECURITY.—Not later than 180 days after the date of the enactment of this Act, the Secretary of the Treasury shall issue regulations regarding mechanical dye injection systems described in the amendment made by subsection (a), and such regulations shall include standards for making such systems tamper resistant.

(c) PENALTY FOR TAMPERING WITH OR FAILING TO MAINTAIN SECURITY REQUIREMENTS FOR MECHANICAL DYE INJECTION SYSTEMS.—

(1) IN GENERAL.—Part I of subchapter B of chapter 68 (relating to assessable penalties) is amended by adding after section 6715 the following new section:

**"SEC. 6715A. TAMPERING WITH OR FAILING TO MAINTAIN SECURITY REQUIREMENTS FOR MECHANICAL DYE INJECTION SYSTEMS.**

"(a) IMPOSITION OF PENALTY—

"(1) TAMPERING.—If any person tampers with a mechanical dye injection system used to indelibly dye fuel for purposes of section 4082, such person shall pay a penalty in addition to the tax (if any).

"(2) FAILURE TO MAINTAIN SECURITY REQUIREMENTS.—If any operator of a mechanical dye injection system used to indelibly dye fuel for purposes of section 4082 fails to maintain the security standards for such system as established by the Secretary, then such operator shall pay a penalty in addition to the tax (if any).

"(b) AMOUNT OF PENALTY.—The amount of the penalty under subsection (a) shall be—

"(1) for each violation described in paragraph (1), the greater of—

"(A) $25,000, or

"(B) $10 for each gallon of fuel involved, and

"(2) for each—

"(A) failure to maintain security standards described in paragraph (2), $1,000, and

"(B) failure to correct a violation described in paragraph (2), $1,000 per day for each day after which such violation was discovered or such person should have reasonably known of such violation.

"(c) JOINT AND SEVERAL LIABILITY.—

"(1) IN GENERAL.—If a penalty is imposed under this section on any business entity, each officer, employee, or agent of such entity or other contracting party who willfully participated in any act giving rise to such penalty shall be jointly and severally liable with such entity for such penalty.

"(2) AFFILIATED GROUPS.—If a business entity described in paragraph (1) is part of an affiliated group (as defined in section 1504(a)), the parent corporation of such entity shall be jointly and severally liable with such entity for the penalty imposed under this section.".

(2) CLERICAL AMENDMENT.—The table of sections for part I of subchapter B of chapter 68 is amended by adding after the item related to section 6715 the following new item:

"Sec. 6715A. Tampering with or failing to maintain security requirements for mechanical dye injection systems.".

(d) EFFECTIVE DATE.—The amendments made by subsections (a) and (c) shall take effect on the 180th day after the date on which the Secretary issues the regulations described in subsection (b).

**SEC. 654. AUTHORITY TO INSPECT ON-SITE RECORDS.**

(a) IN GENERAL.—Section 4083(d)(1)(A) (relating to administrative authority), as previously amended by this Act, is amended by striking "and" at the end of clause (i) and by inserting after clause (ii) the following new clause:

"(iii) inspecting any books and records and any shipping papers pertaining to such fuel, and".

(b) EFFECTIVE DATE.—The amendments made by this section shall take effect on the date of the enactment of this Act.

**SEC. 655. REGISTRATION OF PIPELINE OR VESSEL OPERATORS REQUIRED FOR EXEMPTION OF BULK TRANSFERS TO REGISTERED TERMINALS OR REFINERIES.**

(a) IN GENERAL.—Section 4081(a)(1)(B) (relating to exemption for bulk transfers to registered terminals or refineries) is amended—

(1) by inserting "by pipeline or vessel" after "transferred in bulk", and

(2) by inserting ", the operator of such pipeline or vessel," after "the taxable fuel".

(b) EFFECTIVE DATE.—The amendments made by this section shall take effect on October 1, 2004.

(c) PUBLICATION OF REGISTERED PERSONS.—Beginning on July 1, 2004, the Secretary of the Treasury (or the Secretary's delegate) shall periodically publish a current list of persons registered under section 4101 of the Internal Revenue Code of 1986 who are required to register under such section.

**SEC. 656. DISPLAY OF REGISTRATION.**

(a) IN GENERAL.—Subsection (a) of section 4101 (relating to registration) is amended—

(1) by striking "Every" and inserting the following:

"(1) IN GENERAL.—Every", and

(2) by adding at the end the following new paragraph:

"(2) DISPLAY OF REGISTRATION.—Every operator of a vessel required by the Secretary to register under this section shall display proof of registration through an electronic identification device prescribed by the Secretary on each vessel used by such operator to transport any taxable fuel.".

(b) CIVIL PENALTY FOR FAILURE TO DISPLAY REGISTRATION.—

(1) IN GENERAL.—Part I of subchapter B of chapter 68 (relating to assessable penalties) is amended by inserting after section 6716 the following new section:

**"SEC. 6717. FAILURE TO DISPLAY TAX REGISTRATION ON VESSELS.**

"(a) FAILURE TO DISPLAY REGISTRATION.—Every operator of a vessel who fails to display proof of registration pursuant to section 4101(a)(2) shall pay a penalty of $500 for each such failure. With respect to any vessel, only one penalty shall be imposed by this section during any calendar month.

"(b) MULTIPLE VIOLATIONS.—In determining the penalty under subsection (a) on any person, subsection (a) shall be applied by increasing the amount in subsection (a) by the product of such amount and the aggregate number of penalties (if any) imposed with respect to prior months by this section on such person (or a related person or any predecessor of such person or related person).

"(c) REASONABLE CAUSE EXCEPTION.—No penalty shall be imposed under this section with respect to any failure if it is shown that such failure is due to reasonable cause.".

(2) CLERICAL AMENDMENT.—The table of sections for part I of subchapter B of chapter 68 is amended by inserting after the item relating to section 6716 the following new item:

"Sec. 6717. Failure to display tax registration on vessels.".

(c) EFFECTIVE DATES.—

(1) SUBSECTION (a).—The amendments made by subsection (a) shall take effect on October 1, 2004.

(2) SUBSECTION (b).—The amendments made by subsection (b) shall apply to penalties imposed after September 30, 2004.

**SEC. 657. PENALTIES FOR FAILURE TO REGISTER AND FAILURE TO REPORT.**

(a) INCREASED PENALTY.—Subsection (a) of section 7272 (relating to penalty for failure to register) is amended by inserting "($10,000 in the case of a failure to register under section 4101)" after "$50".

(b) INCREASED CRIMINAL PENALTY.—Section 7232 (relating to failure to register under section 4101, false representations of registration status, etc.) is amended by striking "$5,000" and inserting "$10,000".

(c) ASSESSABLE PENALTY FOR FAILURE TO REGISTER.—

(1) IN GENERAL.—Part I of subchapter B of chapter 68 (relating to assessable penalties) is amended by inserting after section 6717 the following new section:

**"SEC. 6718. FAILURE TO REGISTER.**

"(a) FAILURE TO REGISTER.—Every person who is required to register under section 4101 and fails to do so shall pay a penalty in addition to the tax (if any).

"(b) AMOUNT OF PENALTY.—The amount of the penalty under subsection (a) shall be—

"(1) $10,000 for each initial failure to register, and

"(2) $1,000 for each day thereafter such person fails to register.

"(c) REASONABLE CAUSE EXCEPTION.—No penalty shall be imposed under this section with respect to any failure if it is shown that such failure is due to reasonable cause.".

(2) CLERICAL AMENDMENT.—The table of sections for part I of subchapter B of chapter 68 is amended by inserting after the item relating to section 6717 the following new item:

"Sec. 6718. Failure to register.".

(d) ASSESSABLE PENALTY FOR FAILURE TO REPORT.—

(1) IN GENERAL.—Part II of subchapter B of chapter 68 (relating to assessable penalties) is amended by adding at the end the following new section:

**"SEC. 6725. FAILURE TO REPORT INFORMATION UNDER SECTION 4101.**

"(a) IN GENERAL.—In the case of each failure described in subsection (b) by any person with respect to a vessel or facility, such person shall pay a penalty of $10,000 in addition to the tax (if any).

"(b) FAILURES SUBJECT TO PENALTY.—For purposes of subsection (a), the failures described in this subsection are—

"(1) any failure to make a report under section 4101(d) on or before the date prescribed therefor, and

"(2) any failure to include all of the information required to be shown on such report or the inclusion of incorrect information.

"(c) REASONABLE CAUSE EXCEPTION.—No penalty shall be imposed under this section with respect to any failure if it is shown that such failure is due to reasonable cause.".

(2) CLERICAL AMENDMENT.—The table of sections for part II of subchapter B of chapter 68 is amended by adding at the end the following new item:

"Sec. 6725. Failure to report information under section 4101.".

(e) EFFECTIVE DATE.—The amendments made by this section shall apply to penalties imposed after September 30, 2004.

**SEC. 658. COLLECTION FROM CUSTOMS BOND WHERE IMPORTER NOT REGISTERED.**

(a) TAX AT POINT OF ENTRY WHERE IMPORTER NOT REGISTERED.—Subpart B of part III of subchapter A of chapter 32, as redesignated by section 652(d), is amended by adding after section 4103 the following new section:

**"SEC. 4104. COLLECTION FROM CUSTOMS BOND WHERE IMPORTER NOT REGISTERED.**

"(a) IN GENERAL.—The importer of record shall be jointly and severally liable for the tax imposed by section 4081(a)(1)(A)(iii) if, under regulations prescribed by the Secretary, any other person that is not a person who is registered under section 4101 is liable for such tax.

"(b) COLLECTION FROM CUSTOMS BOND.—If any tax for which any importer of record is liable under subsection (a), or for which any importer of record that is not a person registered under section 4101 is otherwise liable, is not paid on or before the last date prescribed for payment, the Secretary may collect such tax from the Customs bond posted with respect to the importation of the taxable fuel to which the tax relates. For purposes of determining the jurisdiction of any court of the United States or any agency of the United States, any action by the Secretary described in the preceding sentence shall be treated as an action to collect the tax from a bond described in section 4101(b)(1) and not as an action to collect from a bond relating to the importation of merchandise.".

(b) CONFORMING AMENDMENT.—The table of sections for subpart B of part III of subchapter A of chapter 32, as redesignated by section 652(d), is amended by adding after the item related to section 4103 the following new item:

"Sec. 4104. Collection from Customs bond where importer not registered.".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to fuel entered after September 30, 2004.

**SEC. 659. MODIFICATIONS OF TAX ON USE OF CERTAIN VEHICLES.**

(a) PRORATION OF TAX WHERE VEHICLE SOLD.—

(1) IN GENERAL.—Subparagraph (A) of section 4481(c)(2) (relating to where vehicle destroyed or stolen) is amended by striking "destroyed or stolen" both places it appears and inserting "sold, destroyed, or stolen".

(2) CONFORMING AMENDMENT.—The heading for section 4481(c)(2) is amended by striking "DESTROYED OR STOLEN" and inserting "SOLD, DESTROYED, OR STOLEN".

(b) REPEAL OF INSTALLMENT PAYMENT.—

(1) Section 6156 (relating to installment payment of tax on use of highway motor vehicles) is repealed.

(2) The table of sections for subchapter A of chapter 62 is amended by striking the item relating to section 6156.

(c) ELECTRONIC FILING.—Section 4481 is amended by redesignating subsection (e) as subsection (f) and by inserting after subsection (d) the following new subsection:

"(e) ELECTRONIC FILING.—Any taxpayer who files a return under this section with respect to 25 or more vehicles for any taxable period shall file such return electronically.".

(d) REPEAL OF REDUCTION IN TAX FOR CERTAIN TRUCKS.—Section 4483 is amended by striking subsection (f).

(e) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable periods beginning after the date of the enactment of this Act.

**SEC. 660. MODIFICATION OF ULTIMATE VENDOR REFUND CLAIMS WITH RESPECT TO FARMING.**

(a) IN GENERAL.—

(1) REFUNDS.—Section 6427(l) is amended by adding at the end the following new paragraph:

"(6) REGISTERED VENDORS PERMITTED TO ADMINISTER CERTAIN CLAIMS FOR REFUND OF DIESEL FUEL AND KEROSENE SOLD TO FARMERS.—

"(A) IN GENERAL.—In the case of diesel fuel or kerosene used on a farm for farming purposes (within the meaning of section 6420(c)), paragraph (1) shall not apply to the aggregate amount of such diesel fuel or kerosene if such amount does not exceed 250 gallons (as determined under subsection (i)(5)(A)(iii)).

"(B) PAYMENT TO ULTIMATE VENDOR.—The amount which would (but for subparagraph (A)) have been paid under paragraph (1) with respect to any fuel shall be paid to the ultimate vendor of such fuel, if such vendor—

"(i) is registered under section 4101, and

"(ii) meets the requirements of subparagraph (A), (B), or (D) of section 6416(a)(1).".

(2) FILING OF CLAIMS.—Section 6427(i) is amended by inserting at the end the following new paragraph:

"(5) SPECIAL RULE FOR VENDOR REFUNDS WITH RESPECT TO FARMERS.—

"(A) IN GENERAL.—A claim may be filed under subsection (l)(6) by any person with respect to fuel sold by such person for any period—

"(i) for which $200 or more ($100 or more in the case of kerosene) is payable under subsection (l)(6),

"(ii) which is not less than 1 week, and

"(iii) which is for not more than 250 gallons for each farmer for which there is a claim.

Notwithstanding subsection (l)(1), paragraph (3)(B) shall apply to claims filed under the preceding sentence.

"(B) TIME FOR FILING CLAIM.—No claim filed under this paragraph shall be allowed unless filed on or before the last day of the first quarter following the earliest quarter included in the claim.".

(3) CONFORMING AMENDMENTS.—

(A) Section 6427(l)(5)(A) is amended to read as follows:

"(A) IN GENERAL.—Paragraph (1) shall not apply to diesel fuel or kerosene used by a State or local government.".

(B) The heading for section 6427(l)(5) is amended by striking "FARMERS AND".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to fuels sold for nontaxable use after the date of the enactment of this Act.

**SEC. 661. DEDICATION OF REVENUES FROM CERTAIN PENALTIES TO THE HIGHWAY TRUST FUND.**

(a) IN GENERAL.—Subsection (b) of section 9503 (relating to transfer to Highway Trust Fund of amounts equivalent to certain taxes) is amended by redesignating paragraph (5) as paragraph (6) and inserting after paragraph (4) the following new paragraph:

"(5) CERTAIN PENALTIES.—There are hereby appropriated to the Highway Trust Fund amounts equivalent to the penalties paid under sections 6715, 6715A, 6717, 6718, 6725, 7232, and 7272 (but only with regard to penalties under such section related to failure to register under section 4101).".

(b) CONFORMING AMENDMENTS.—

(1) The heading of subsection (b) of section 9503 is amended by inserting "AND PENALTIES" after "TAXES".

(2) The heading of paragraph (1) of section 9503(b) is amended by striking "IN GENERAL" and inserting "CERTAIN TAXES".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to penalties assessed after October 1, 2004.

**SEC. 662. TAXABLE FUEL REFUNDS FOR CERTAIN ULTIMATE VENDORS.**

(a) IN GENERAL.—Paragraph (4) of section 6416(a) (relating to abatements, credits, and refunds) is amended to read as follows:

"(4) REGISTERED ULTIMATE VENDOR TO ADMINISTER CREDITS AND REFUNDS OF GASOLINE TAX.—

"(A) IN GENERAL.—For purposes of this subsection, if an ultimate vendor purchases any gasoline on which tax imposed by section 4081 has been paid and sells such gasoline to an ultimate purchaser described in subparagraph (C) or (D) of subsection (b)(2) (and such gasoline is for a use described in such subparagraph), such ultimate vendor shall be treated as the person (and the only person) who paid such tax, but only if such ultimate vendor is registered under section 4101. For purposes of this subparagraph, if the sale of gasoline is made by means of a credit card, the person extending the credit to the ultimate purchaser shall be deemed to be the ultimate vendor.

"(B) TIMING OF CLAIMS.—The procedure and timing of any claim under subparagraph (A) shall be the same as for claims under section 6427(i)(4), except that the rules of section 6427(i)(3)(B) regarding electronic claims shall not apply unless the ultimate vendor has certified to the Secretary for the most recent quarter of the taxable year that all ultimate purchasers of the vendor covered by such claim are certified and entitled to a refund under subparagraph (C) or (D) of subsection (b)(2).".

(b) CREDIT CARD PURCHASES OF DIESEL FUEL OR KEROSENE BY STATE AND LOCAL GOVERNMENTS.—Section 6427(l)(5)(C) (relating to nontaxable uses of diesel fuel, kerosene, and aviation fuel) is amended by adding at the end the following new flush sentence: "For purposes of this subparagraph, if the sale of diesel fuel or kerosene is made by means of a credit card, the person extending the credit to the ultimate purchaser shall be deemed to be the ultimate vendor.".

(c) EFFECTIVE DATE.—The amendments made by this section shall take effect on October 1, 2004.

**SEC. 663. TWO-PARTY EXCHANGES.**

(a) IN GENERAL.—Subpart B of part III of subchapter A of chapter 32, as amended by this Act, is amended by adding after section 4104 the following new section:

**"SEC. 4105. TWO-PARTY EXCHANGES.**

"(a) IN GENERAL.—In a two-party exchange, the delivering person shall not be liable for the tax imposed under section 4081(a)(1)(A)(ii).

"(b) TWO-PARTY EXCHANGE.—The term 'two-party exchange' means a transaction, other than a sale, in which taxable fuel is transferred from a delivering person registered under section 4101 as a taxable fuel registrant fuel to a receiving person who is so registered where all of the following occur:

"(1) The transaction includes a transfer from the delivering person, who holds the inventory position for taxable fuel in the terminal as reflected in the records of the terminal operator.

"(2) The exchange transaction occurs before or contemporaneous with completion of removal across the rack from the terminal by the receiving person.

"(3) The terminal operator in its books and records treats the receiving person as the person that removes the taxable fuel across the terminal rack for purposes of reporting the transaction to the Secretary.

"(4) The transaction is the subject of a written contract.".

(b) CONFORMING AMENDMENT.—The table of sections for subpart B of part III of subchapter A of chapter 32, as amended by this Act, is amended by adding after the item relating to section 4104 the following new item:

*"Sec. 4105. Two-party exchanges.".*

(c) EFFECTIVE DATE.—The amendment made by this section shall take effect on the date of the enactment of this Act.

**SEC. 664. SIMPLIFICATION OF TAX ON TIRES.**

(a) IN GENERAL.—Subsection (a) of section 4071 is amended to read as follows:

"(a) IMPOSITION AND RATE OF TAX.—There is hereby imposed on taxable tires sold by the manufacturer, producer, or importer thereof a tax at the rate of 9.4 cents (4.7 cents in the case of a biasply tire) for each 10 pounds so much of the maximum rated load capacity thereof as exceeds 3,500 pounds."

(b) TAXABLE TIRE.—Section 4072 is amended by redesignating subsections (a) and (b) as subsections (b) and (c), respectively, and by inserting before subsection (b) (as so redesignated) the following new subsection:

"(a) TAXABLE TIRE.—For purposes of this chapter, the term 'taxable tire' means any tire of the type used on highway vehicles if wholly or in part made of rubber and if marked pursuant to Federal regulations for highway use."

(c) EXEMPTION FOR TIRES SOLD TO DEPARTMENT OF DEFENSE.—Section 4073 is amended to read as follows:

**"SEC. 4073. EXEMPTIONS.**

"The tax imposed by section 4071 shall not apply to tires sold for the exclusive use of the Department of Defense or the Coast Guard."

(d) CONFORMING AMENDMENTS.—

(1) Section 4071 is amended by striking subsection (c) and by moving subsection (e) after subsection (b) and redesignating subsection (e) as subsection (c).

(2) The item relating to section 4073 in the table of sections for part II of subchapter A of chapter 32 is amended to read as follows:

"Sec. 4073. Exemptions."

(e) EFFECTIVE DATE.—The amendments made by this section shall apply to sales in calendar years beginning more than 30 days after the date of the enactment of this Act.

# Subtitle D—Nonqualified Deferred Compensation Plans

**SEC. 671. TREATMENT OF NONQUALIFIED DEFERRED COMPENSATION PLANS.**

(a) IN GENERAL.—Subpart A of part I of subchapter D of chapter 1 is amended by adding at the end the following new section:

**"SEC. 409A. INCLUSION IN GROSS INCOME OF DEFERRED COMPENSATION UNDER NONQUALIFIED DEFERRED COMPENSATION PLANS.**

"(a) RULES RELATING TO CONSTRUCTIVE RECEIPT.—

"(1) IN GENERAL.—

"(A) GROSS INCOME INCLUSION.—In the case of a nonqualified deferred compensation plan, all compensation deferred under the plan for all taxable years (to the extent not subject to a substantial risk of forfeiture and not previously included in gross income) shall be includible in gross income for the taxable year unless at all times during the taxable year the plan meets the requirements of paragraphs (2), (3), and (4) and is operated in accordance with such requirements.

"(B) INTEREST ON TAX LIABILITY PAYABLE WITH RESPECT TO PREVIOUSLY DEFERRED COMPENSATION.—

"(i) IN GENERAL.—If compensation is required to be included in gross income under subparagraph (A) for a taxable year, the tax imposed by this chapter for such taxable year shall be increased by the amount of interest determined under clause (ii).

"(ii) INTEREST.—For purposes of clause (i), the interest determined under this clause for any taxable year is the amount of interest at the underpayment rate plus 1 percentage point on the underpayments that would have occurred had the deferred compensation been includible in gross income for the taxable year in which first deferred or, if later, the first taxable year in which such deferred compensation is not subject to a substantial risk of forfeiture.

"(2) DISTRIBUTIONS.—

"(A) IN GENERAL.—The requirements of this paragraph are met if the plan provides that compensation deferred under the plan may not be distributed earlier than—

"(i) separation from service as determined by the Secretary (except as provided in subparagraph (B)(i)),

"(ii) the date the participant becomes disabled (within the meaning of subparagraph (C)),

"(iii) death,

"(iv) a specified time (or pursuant to a fixed schedule) specified under the plan at the date of the deferral of such compensation,

"(v) to the extent provided by the Secretary, a change in the ownership or effective control of the corporation, or in the ownership of a substantial portion of the assets of the corporation, or

"(vi) the occurrence of an unforeseeable emergency.

"(B) SPECIAL RULES.—

"(i) SPECIFIED EMPLOYEES.—In the case of specified employees, the requirement of subparagraph (A)(i) is met only if distributions may not be made earlier than 6 months after the date of separation from service. For purposes of the preceding sentence, a specified employee is a key employee (as defined in section 416(i)) of a corporation the stock in which is publicly traded on an established securities market or otherwise.

"(ii) UNFORESEEABLE EMERGENCY.—For purposes of subparagraph (A)(vi)—

"(I) IN GENERAL.—The term 'unforeseeable emergency' means a severe financial hardship to the participant resulting from a sudden and unexpected illness or accident of the participant, the participant's spouse, or a dependent (as defined in section 152(a)) of the participant, loss of the participant's property due to casualty, or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant.

"(II) LIMITATION ON DISTRIBUTIONS.—The requirement of subparagraph (A)(vi) is met only if, as determined under regulations of the Secretary, the amounts distributed with respect to an emergency do not exceed the amounts necessary to satisfy such emergency plus amounts necessary to pay taxes reasonably anticipated as a result of the distribution, after taking into account the extent to which such hardship is or may be relieved through reimbursement or compensation by insurance or otherwise or by liquidation of the participant's assets (to the extent the liquidation of such assets would not itself cause severe financial hardship).

"(C) DISABLED.—For purposes of subparagraph (A)(ii), a participant shall be considered disabled if the participant—

"(i) is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, or

"(ii) is, by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, receiving income replacement benefits for a period of not less than 3 months under an accident and health plan covering employees of the participant's employer.

"(3) ACCELERATION OF BENEFITS.—The requirements of this paragraph are met if the plan does not permit the acceleration of the time or schedule of any payment under the plan, except as provided in regulations by the Secretary.

"(4) ELECTIONS.—

"(A) IN GENERAL.—The requirements of this paragraph are met if the requirements of subparagraphs (B) and (C) are met.

"(B) INITIAL DEFERRAL DECISION.—The requirements of this subparagraph are met if the plan provides that compensation for services performed during a taxable year may be deferred at the participant's election only if the election to defer such compensation is made not later than the close of the preceding taxable year or at such other time as provided in regulations. In the case of the first year in which a participant becomes eligible to participate in the plan, such election may be made with respect to services to be performed subsequent to the election within 30 days after the date the participant becomes eligible to participate in such plan.

"(C) CHANGES IN TIME AND FORM OF DISTRIBUTION.—The requirements of this subparagraph are met if, in the case of a plan which permits under a subsequent election a delay in a payment or a change in the form of payment—

"(i) the plan requires that such election may not take effect until at least 12 months after the date on which the election is made,

"(ii) in the case an election related to a payment not described in clause (ii), (iii), or (vi) of paragraph (2)(A), the plan requires that the first payment with respect to which such election is made be deferred for a period of not less than 5 years from the date such payment would otherwise have been made, and

"(iii) the plan requires that any election related to a payment described in paragraph (2)(A)(iv) may not be made less than 12 months prior to the date of the first scheduled payment under such paragraph.

"(b) RULES RELATING TO FUNDING.—

"(1) OFFSHORE PROPERTY IN A TRUST.—In the case of assets set aside (directly or indirectly) in a trust (or other arrangement determined by the Secretary) for purposes of paying deferred compensation under a nonqualified deferred compensation plan, for purposes of section 83 such assets shall be treated as property transferred in connection with the performance of services whether or not such assets are available to satisfy claims of general creditors—

"(A) at the time set aside if such assets are located outside of the United States, or

"(B) at the time transferred if such assets are subsequently transferred outside of the United States.

"(2) EMPLOYER'S FINANCIAL HEALTH.—In the case of compensation deferred under a nonqualified deferred compensation plan, there is a transfer of property within the meaning of section 83 with respect to such compensation as of the earlier of—

"(A) the date on which the plan first provides that assets will become restricted to the provision of benefits under the plan in connection with a change in the employer's financial health, or

"(B) the date on which assets are so restricted.

"(3) INCOME INCLUSION FOR OFFSHORE TRUSTS AND EMPLOYER'S FINANCIAL HEALTH.—For each taxable year that assets treated as transferred under this subsection remain set aside in a trust or other arrangement subject to paragraph (1) or (2), any increase in value in, or earnings with respect to, such assets shall be treated as an additional transfer of property under this subsection (to the extent not previously included in income).

"(4) INTEREST ON TAX LIABILITY PAYABLE WITH RESPECT TO TRANSFERRED PROPERTY.—

"(A) IN GENERAL.—If amounts are required to be included in gross income by reason of paragraph (1) or (2) for a taxable year, the tax imposed by this chapter for such taxable year shall be increased by the amount of interest determined under subparagraph (B).

"(B) INTEREST.—The interest determined under this subparagraph for any taxable year is the amount of interest at the underpayment rate plus 1 percentage point on the underpayments that would have occurred had the

amounts so required to be included in gross income by paragraph (1) or (2) been includible in gross income for the taxable year in which first deferred or, if later, the first taxable year in which such deferred compensation is not subject to a substantial risk of forfeiture.

"(c) NO INFERENCE ON EARLIER INCOME INCLUSION OR REQUIREMENT OF LATER INCLUSION.—Nothing in this section shall be construed to prevent the inclusion of amounts in gross income under any other provision of this chapter or any other rule of law earlier than the time provided in this section. Any amount included in gross income under this section shall not be required to be included in gross income under any other provision of this chapter or any other rule of law later than the time provided in this section.

"(d) OTHER DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

"(1) NONQUALIFIED DEFERRED COMPENSATION PLAN.—The term 'nonqualified deferred compensation plan' means any plan that provides for the deferral of compensation, other than—

"(A) a qualified employer plan, and

"(B) any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan.

"(2) QUALIFIED EMPLOYER PLAN.—The term 'qualified employer plan' means—

"(A) any plan, contract, pension, account, or trust described in subparagraph (A) or (B) of section 219(g)(5), and

"(B) any eligible deferred compensation plan (within the meaning of section 457(b)) of an employer described in section 457(e)(1)(A).

"(3) PLAN INCLUDES ARRANGEMENTS, ETC.—The term 'plan' includes any agreement or arrangement, including an agreement or arrangement that includes one person.

"(4) SUBSTANTIAL RISK OF FORFEITURE.—The rights of a person to compensation are subject to a substantial risk of forfeiture if such person's rights to such compensation are conditioned upon the future performance of substantial services by any individual.

"(5) TREATMENT OF EARNINGS.—References to deferred compensation shall be treated as including references to income (whether actual or notional) attributable to such compensation or such income.

"(e) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including regulations—

"(1) providing for the determination of amounts of deferral in the case of a nonqualified deferred compensation plan which is a defined benefit plan,

"(2) relating to changes in the ownership and control of a corporation or assets of a corporation for purposes of subsection (a)(2)(A)(v),

"(3) exempting arrangements from the application of subsection (b) if such arrangements will not result in an improper deferral of United States tax and will not result in assets being effectively beyond the reach of creditors,

"(4) defining financial health for purposes of subsection (b)(2), and

"(5) disregarding a substantial risk of forfeiture in cases where necessary to carry out the purposes of this section.".

(b) W–2 FORMS.—

(1) IN GENERAL.—Subsection (a) of section 6051 (relating to receipts for employees) is amended by striking "and" at the end of paragraph (11), by striking the period at the end of paragraph (12) and inserting ", and", and by inserting after paragraph (12) the following new paragraph:

"(13) the total amount of deferrals under a nonqualified deferred compensation plan (within the meaning of section 409A(d)).".

(2) THRESHOLD.—Subsection (a) of section 6051 is amended by adding at the end the following: "In the case of the amounts required to be shown by paragraph (13), the Secretary (by regulation) may establish a minimum amount of deferrals below which paragraph (13) does not apply and may provide that paragraph (13) does not apply with respect to amounts of deferrals which are not reasonably ascertainable.".

(c) CONFORMING AND CLERICAL AMENDMENTS.—

(1) Section 414(b) is amended by inserting "409A," after "408(p),".

(2) Section 414(c) is amended by inserting "409A," after "408(p),".

(3) The table of sections for such subpart A of part I of subchapter D of chapter 1 is amended by adding at the end the following new item:

"Sec. 409A. Inclusion in gross income of deferred compensation under nonqualified deferred compensation plans.".

(d) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendments made by this section shall apply to amounts deferred after June 3, 2004.

(2) CERTAIN AMOUNTS DEFERRED IN 2004 UNDER CERTAIN IRREVOCABLE ELECTIONS AND BINDING ARRANGEMENTS.—The amendments made by this section shall not apply to amounts deferred after June 3, 2004, and before January 1, 2005, pursuant to an irrevocable election or binding arrangement made before June 4, 2004.

(3) EARNINGS ATTRIBUTABLE TO AMOUNT PREVIOUSLY DEFERRED.—The amendments made by this section shall apply to earnings on deferred compensation only to the extent that such amendments apply to such compensation.

(e) GUIDANCE RELATING TO CHANGE OF OWNERSHIP OR CONTROL.—Not later than 90 days after the date of the enactment of this Act, the Secretary of the Treasury shall issue guidance on what constitutes a change in ownership or effective control for purposes of section 409A of the Internal Revenue Code of 1986, as added by this section.

(f) GUIDANCE RELATING TO TERMINATION OF CERTAIN EXISTING ARRANGEMENTS.—Not later than 90 days after the date of the enactment of this Act, the Secretary of the Treasury shall issue guidance providing a limited period during which an individual participating in a nonqualified deferred compensation plan adopted before June 4, 2004, may, without violating the requirements of paragraphs (2), (3), and (4) of section 409A(a)(2) of the Internal Revenue Code of 1986 (as added by this section), terminate participation or cancel an outstanding deferral election with regard to amounts earned after June 3, 2004, if such amounts are includible in income as earned.

# Subtitle E—Other Revenue Provisions

**SEC. 681. QUALIFIED TAX COLLECTION CONTRACTS.**

(a) CONTRACT REQUIREMENTS.—

(1) IN GENERAL.—Subchapter A of chapter 64 (relating to collection) is amended by adding at the end the following new section:

**"SEC. 6306. QUALIFIED TAX COLLECTION CONTRACTS.**

"(a) IN GENERAL.—Nothing in any provision of law shall be construed to prevent the Secretary from entering into a qualified tax collection contract.

"(b) QUALIFIED TAX COLLECTION CONTRACT.—For purposes of this section, the term 'qualified tax collection contract' means any contract which—

"(1) is for the services of any person (other than an officer or employee of the Treasury Department)—

"(A) to locate and contact any taxpayer specified by the Secretary,

"(B) to request full payment from such taxpayer of an amount of Federal tax specified by the Secretary and, if such request cannot be met by the taxpayer, to offer the taxpayer an installment agreement providing for full payment of such amount during a period not to exceed 5 years, and

"(C) to obtain financial information specified by the Secretary with respect to such taxpayer,

"(2) prohibits each person providing such services under such contract from committing any act or omission which employees of the Internal Revenue Service are prohibited from committing in the performance of similar services,

"(3) prohibits subcontractors from—

"(A) having contacts with taxpayers,

"(B) providing quality assurance services, and

"(C) composing debt collection notices, and

"(4) permits subcontractors to perform other services only with the approval of the Secretary.

"(c) FEES.—The Secretary may retain and use an amount not in excess of 25 percent of the amount collected under any qualified tax collection contract for the costs of services performed under such contract. The Secretary shall keep adequate records regarding amounts so retained and used. The amount credited as paid by any taxpayer shall be determined without regard to this subsection.

"(d) NO FEDERAL LIABILITY.—The United States shall not be liable for any act or omission of any person performing services under a qualified tax collection contract.

"(e) APPLICATION OF FAIR DEBT COLLECTION PRACTICES ACT.—The provisions of the Fair Debt Collection Practices Act (15 U.S.C. 1692 et seq.) shall apply to any qualified tax collection contract, except to the extent superseded by section 6304, section 7602(c), or by any other provision of this title.

"(f) CROSS REFERENCES.—

**"(1) For damages for certain unauthorized collection actions by persons performing services under a qualified tax collection contract, see section 7433A.**

**"(2) For application of Taxpayer Assistance Orders to persons performing services under a qualified tax collection contract, see section 7811(a)(4).".**

(2) CONFORMING AMENDMENTS.—

(A) Section 7809(a) is amended by inserting "6306," before "7651".

(B) The table of sections for subchapter A of chapter 64 is amended by adding at the end the following new item:

"Sec. 6306. Qualified Tax Collection Contracts.".

(b) CIVIL DAMAGES FOR CERTAIN UNAUTHORIZED COLLECTION ACTIONS BY PERSONS PERFORMING SERVICES UNDER QUALIFIED TAX COLLECTION CONTRACTS.—

(1) In general.—Subchapter B of chapter 76 (relating to proceedings by taxpayers and third parties) is amended by inserting after section 7433 the following new section:

**"SEC. 7433A. CIVIL DAMAGES FOR CERTAIN UNAUTHORIZED COLLECTION ACTIONS BY PERSONS PERFORMING SERVICES UNDER QUALIFIED TAX COLLECTION CONTRACTS.**

"(a) IN GENERAL.—Subject to the modifications provided by subsection (b), section 7433 shall apply to the acts and omissions of any person performing services under a qualified tax collection contract (as defined in section 6306(b)) to the same extent and in the same manner as if such person were an employee of the Internal Revenue Service.

"(b) MODIFICATIONS.—For purposes of subsection (a)—

"(1) Any civil action brought under section 7433 by reason of this section shall be brought against the person who entered into the qualified tax collection contract with the Secretary and shall not be brought against the United States.

"(2) Such person and not the United States shall be liable for any damages and costs determined in such civil action.

"(3) Such civil action shall not be an exclusive remedy with respect to such person.

"(4) Subsections (c), (d)(1), and (e) of section 7433 shall not apply.".

(2) CLERICAL AMENDMENT.—The table of sections for subchapter B of chapter 76 is amended by inserting after the item relating to section 7433 the following new item:

*"Sec. 7433A. Civil damages for certain unauthorized collection actions by persons performing services under qualified tax collection contracts.".*

(c) APPLICATION OF TAXPAYER ASSISTANCE ORDERS TO PERSONS PERFORMING SERVICES UNDER A QUALIFIED TAX COLLECTION CONTRACT.—Section 7811 (relating to taxpayer assistance orders) is amended by adding at the end the following new subsection:

"(g) APPLICATION TO PERSONS PERFORMING SERVICES UNDER A QUALIFIED TAX COLLECTION CONTRACT.—Any order issued or action taken by the National Taxpayer Advocate pursuant to this section shall apply to persons performing services under a qualified tax collection contract (as defined in section 6306(b)) to the same extent and in the same manner as such order or action applies to the Secretary.".

(d) INELIGIBILITY OF INDIVIDUALS WHO COMMIT MISCONDUCT TO PERFORM UNDER CONTRACT.—Section 1203 of the Internal Revenue Service Restructuring Act of 1998 (relating to termination of employment for misconduct) is amended by adding at the end the following new subsection:

"(e) INDIVIDUALS PERFORMING SERVICES UNDER A QUALIFIED TAX COLLECTION CONTRACT.—An individual shall cease to be permitted to perform any services under any qualified tax collection contract (as defined in section 6306(b) of the Internal Revenue Code of 1986) if there is a final determination by the Secretary of the Treasury under such contract that such individual committed any act or omission described under subsection (b) in connection with the performance of such services.".

(e) EFFECTIVE DATE.—The amendments made to this section shall take effect on the date of the enactment of this Act.

**SEC. 682. TREATMENT OF CHARITABLE CONTRIBUTIONS OF PATENTS AND SIMILAR PROPERTY.**

(a) IN GENERAL.—Subparagraph (B) of section 170(e)(1) is amended by striking "or" at the end of clause (i), by adding "or" at the end of clause (ii), and by inserting after clause (ii) the following new clause:

"(iii) of any patent, copyright (other than a copyright described in section 1221(a)(3) or 1231(b)(1)(C)), trademark, trade name, trade secret, know-how, software (other than software described in section 197(e)(3)(A)(i)), or similar property, or applications or registrations of such property,".

(b) CERTAIN DONEE INCOME FROM INTELLECTUAL PROPERTY TREATED AS AN ADDITIONAL CHARITABLE CONTRIBUTION.—Section 170 is amended by redesignating subsection (m) as subsection (n) and by inserting after subsection (l) the following new subsection:

"(m) CERTAIN DONEE INCOME FROM INTELLECTUAL PROPERTY TREATED AS AN ADDITIONAL CHARITABLE CONTRIBUTION.—

"(1) TREATMENT AS ADDITIONAL CONTRIBUTION.—In the case of a taxpayer who makes a qualified intellectual property contribution, the deduction allowed under subsection (a) for each taxable year of the taxpayer ending on or after the date of such contribution shall be increased (subject to the limitations under subsection (b)) by the applicable percentage of qualified donee income with respect to such contribution which is properly allocable to such year under this subsection.

"(2) REDUCTION IN ADDITIONAL DEDUCTIONS TO EXTENT OF INITIAL DEDUCTION.—With respect to any qualified intellectual property contribution, the deduction allowed under subsection (a) shall be increased under paragraph (1) only to the extent that the aggregate amount of such increases with respect to such contribution exceed the amount allowed as a deduction under subsection (a) with respect to such contribution determined without regard to this subsection.

"(3) QUALIFIED DONEE INCOME.—For purposes of this subsection, the term 'qualified donee income' means any net income received by or accrued to the donee which is properly allocable to the qualified intellectual property.

"(4) ALLOCATION OF QUALIFIED DONEE INCOME TO TAXABLE YEARS OF DONOR.—For purposes of this subsection, qualified donee income shall be treated as properly allocable to a taxable year of the donor if such income is received by or accrued to the donee for the taxable year of the donee which ends within or with such taxable year of the donor.

"(5) 10-YEAR LIMITATION.—Income shall not be treated as properly allocable to qualified intellectual property for purposes of this subsection if such income is received by or accrued to the donee after the 10-year period beginning on the date of the contribution of such property.

"(6) BENEFIT LIMITED TO LIFE OF INTELLECTUAL PROPERTY.—Income shall not be treated as properly allocable to qualified intellectual property for purposes of this subsection if such income is received by or accrued to the donee after the expiration of the legal life of such property.

"(7) APPLICABLE PERCENTAGE.—For purposes of this subsection, the term 'applicable percentage' means the percentage determined under the following table which corresponds to a taxable year of the donor ending on or after the date of the qualified intellectual property contribution:

| "Taxable Year of Donor Ending on or After Date of Contribution: | Applicable Percentage: |
|---|---|
| 1st | 100 |
| 2nd | 100 |
| 3rd | 90 |
| 4th | 80 |
| 5th | 70 |
| 6th | 60 |
| 7th | 50 |
| 8th | 40 |
| 9th | 30 |
| 10th | 20 |
| 11th | 10 |
| 12th | 10. |

"(8) QUALIFIED INTELLECTUAL PROPERTY CONTRIBUTION.—For purposes of this subsection, the term 'qualified intellectual property contribution' means any charitable contribution of qualified intellectual property—

"(A) the amount of which taken into account under this section is reduced by reason of subsection (e)(1), and

"(B) with respect to which the donor informs the donee at the time of such contribution that the donor intends to treat such contribution as a qualified intellectual property contribution for purposes of this subsection and section 6050L.

"(9) QUALIFIED INTELLECTUAL PROPERTY.—For purposes of this subsection, the term 'qualified intellectual property' means property described in subsection (e)(1)(B)(iii) (other than property contributed to or for the use of an organization described in subsection (e)(1)(B)(ii)).

"(10) OTHER SPECIAL RULES.—

"(A) APPLICATION OF LIMITATIONS ON CHARITABLE CONTRIBUTIONS.—Any increase under this subsection of the deduction provided under subsection (a) shall be treated for purposes of subsection (b) as a deduction which is

attributable to a charitable contribution to the donee to which such increase relates.

"(B) NET INCOME DETERMINED BY DONEE.—The net income taken into account under paragraph (3) shall not exceed the amount of such income reported under section 6050L(b)(1).

"(C) DEDUCTION LIMITED TO 12 TAXABLE YEARS.—Except as may be provided under subparagraph (D)(i), this subsection shall not apply with respect to any qualified intellectual property contribution for any taxable year of the donor after the 12th taxable year of the donor which ends on or after the date of such contribution.

"(D) REGULATIONS.—The Secretary may issue regulations or other guidance to carry out the purposes of this subsection, including regulations or guidance—

"(i) modifying the application of this subsection in the case of a donor or donee with a short taxable year, and

"(ii) providing for the determination of an amount to be treated as net income of the donee which is properly allocable to qualified intellectual property in the case of a donee who uses such property to further a purpose or function constituting the basis of the donee's exemption under section 501 (or, in the case of a governmental unit, any purpose described in section 170(c)) and does not possess a right to receive any payment from a third party with respect to such property.".

(c) REPORTING REQUIREMENTS.—

(1) IN GENERAL.—Section 6050L (relating to returns relating to certain dispositions of donated property) is amended to read as follows:

**"SEC. 6050L. RETURNS RELATING TO CERTAIN DONATED PROPERTY.**

"(a) DISPOSITIONS OF DONATED PROPERTY.—

"(1) IN GENERAL.—If the donee of any charitable deduction property sells, exchanges, or otherwise disposes of such property within 2 years after its receipt, the donee shall make a return (in accordance with forms and regulations prescribed by the Secretary) showing—

"(A) the name, address, and TIN of the donor,

"(B) a description of the property,

"(C) the date of the contribution,

"(D) the amount received on the disposition, and

"(E) the date of such disposition.

"(2) DEFINITIONS.—For purposes of this subsection—

"(A) CHARITABLE DEDUCTION PROPERTY.—The term 'charitable deduction property' means any property (other than publicly traded securities) contributed in a contribution for which a deduction was claimed under section 170 if the claimed value of such property (plus the claimed value of all similar items of property donated by the donor to 1 or more donees) exceeds $5,000.

"(B) PUBLICLY TRADED SECURITIES.—The term 'publicly traded securities' means securities for which (as of the date of the contribution) market quotations are readily available on an established securities market.

"(b) QUALIFIED INTELLECTUAL PROPERTY CONTRIBUTIONS.—

"(1) IN GENERAL.—Each donee with respect to a qualified intellectual property contribution shall make a return (at such time and in such form and manner as the Secretary may by regulations prescribe) with respect to each specified taxable year of the donee showing—

"(A) the name, address, and TIN of the donor,

"(B) a description of the qualified intellectual property contributed,

"(C) the date of the contribution, and

"(D) the amount of net income of the donee for the taxable year which is properly allocable to the qualified intellectual property (determined without regard to paragraph (10)(B) of section 170(m) and with the modifications described in paragraphs (5) and (6) of such section).

"(2) DEFINITIONS.—For purposes of this subsection—

"(A) IN GENERAL.—Terms used in this subsection which are also used in section 170(m) have the respective meanings given such terms in such section.

"(B) SPECIFIED TAXABLE YEAR.—The term 'specified taxable year' means, with respect to any qualified intellectual property contribution, any taxable year of the donee any portion of which is part of the 10-year period beginning on the date of such contribution.

"(c) STATEMENT TO BE FURNISHED TO DONORS.—Every person making a return under subsection (a) or (b) shall furnish a copy of such return to the donor at such time and in such manner as the Secretary may by regulations prescribe.".

(2) CLERICAL AMENDMENT.—The table of sections for subpart A of part II of subchapter A of chapter 61 is amended by striking the item relating to section 6050L and inserting the following new item:

"Sec. 6050L. Returns relating to certain donated property.".

(d) COORDINATION WITH APPRAISAL REQUIREMENTS.—Subclause (I) of section 170(f)(11)(A)(ii), as added by section 683, is amended by inserting "subsection (e)(1)(B)(iii) or" before "section 1221(a)(1)".

(e) ANTI-ABUSE RULES.—The Secretary of the Treasury may prescribe such regulations or other guidance as may be necessary or appropriate to prevent the avoidance of the purposes of section 170(e)(1)(B)(iii) of the Internal Revenue Code of 1986 (as added by subsection (a)), including preventing—

(1) the circumvention of the reduction of the charitable deduction by embedding or bundling the patent or similar property as part of a charitable contribution of property that includes the patent or similar property,

(2) the manipulation of the basis of the property to increase the amount of the charitable deduction through the use of related persons, pass-thru entities, or other intermediaries, or through the use of any provision of law or regulation (including the consolidated return regulations), and

(3) a donor from changing the form of the patent or similar property to property of a form for which different deduction rules would apply.

(f) EFFECTIVE DATE.—The amendments made by this section shall apply to contributions made after June 3, 2004.

**SEC. 683. INCREASED REPORTING FOR NONCASH CHARITABLE CONTRIBUTIONS.**

(a) IN GENERAL.—Subsection (f) of section 170 (relating to disallowance of deduction in certain cases and special rules) is amended by adding after paragraph (10) the following new paragraph:

"(11) QUALIFIED APPRAISAL AND OTHER DOCUMENTATION FOR CERTAIN CONTRIBUTIONS.—

"(A) IN GENERAL.—

"(i) DENIAL OF DEDUCTION.—In the case of an individual, partnership, or corporation, no deduction shall be allowed under subsection (a) for any contribution of property for which a deduction of more than $500 is claimed unless such person meets the requirements of subparagraphs (B), (C), and (D), as the case may be, with respect to such contribution.

"(ii) EXCEPTIONS.—

"(I) READILY VALUED PROPERTY.—Subparagraphs (C) and (D) shall not apply to cash, property described in section 1221(a)(1), and publicly traded securities (as defined in section 6050L(a)(2)(B)).

"(II) REASONABLE CAUSE.—Clause (i) shall not apply if it is shown that the failure to meet such requirements is due to reasonable cause and not to willful neglect.

"(B) PROPERTY DESCRIPTION FOR CONTRIBUTIONS OF MORE THAN $500.—In the case of contributions of property for which a deduction of more than $500 is claimed, the requirements of this subparagraph are met if the individual, partnership or corporation includes with the return for the taxable year in which the contribution is made a description of such property and such other information as the Secretary may require. The requirements of this subparagraph shall not apply to a C corporation which is not a personal service corporation or a closely held C corporation.

"(C) QUALIFIED APPRAISAL FOR CONTRIBUTIONS OF MORE THAN $5,000.—In the case of contributions of property for which a deduction of more than $5,000 is claimed, the requirements of this subparagraph are met if the individual, partnership, or corporation obtains a qualified appraisal of such property and attaches to the return for the taxable year in which such contribution is made such information regarding such property and such appraisal as the Secretary may require.

"(D) SUBSTANTIATION FOR CONTRIBUTIONS OF MORE THAN $500,000.—In the case of contributions of property for which a deduction of more than $500,000 is claimed, the requirements of this subparagraph are met if the individual, partnership, or corporation attaches to the return for the taxable year a qualified appraisal of such property.

"(E) QUALIFIED APPRAISAL.—For purposes of this paragraph, the term 'qualified appraisal' means, with respect to any property, an appraisal of

such property which is treated for purposes of this paragraph as a qualified appraisal under regulations or other guidance prescribed by the Secretary.

"(F) AGGREGATION OF SIMILAR ITEMS OF PROPERTY.—For purposes of determining thresholds under this paragraph, property and all similar items of property donated to 1 or more donees shall be treated as 1 property.

"(G) SPECIAL RULE FOR PASS-THRU ENTITIES.—In the case of a partnership or S corporation, this paragraph shall be applied at the entity level, except that the deduction shall be denied at the partner or shareholder level.

"(H) REGULATIONS.—The Secretary may prescribe such regulations as may be necessary or appropriate to carry out the purposes of this paragraph, including regulations that may provide that some or all of the requirements of this paragraph do not apply in appropriate cases.".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to contributions made after June 3, 2004.

**SEC. 684. DONATIONS OF MOTOR VEHICLES, BOATS, AND AIRCRAFT.**

(a) IN GENERAL.—Subsection (f) of section 170 (relating to disallowance of deduction in certain cases and special rules) is amended by adding after paragraph (11) the following new paragraph:

"(12) CONTRIBUTIONS OF MOTOR VEHICLES, BOATS, AND AIRCRAFT.—

"(A) IN GENERAL.—Except as provided in regulations or other guidance, in the case of a contribution of a specified vehicle to which paragraph (8) applies, no deduction shall be allowed under subsection (a) for such contribution unless the taxpayer obtains a qualified appraisal of the specified vehicle on or before the date of such contribution.

"(B) EXCEPTION FOR INVENTORY PROPERTY.—Subparagraph (A) shall not apply to property which is described in section 1221(a)(1).

"(C) SPECIFIED VEHICLE.—For purposes of this paragraph, the term 'specified vehicle' means any—

"(i) motor vehicle manufactured primarily for use on public streets, roads, and highways,

"(ii) boat, or

"(iii) aircraft.

"(D) QUALIFIED APPRAISAL.—For purposes of this paragraph, the term 'qualified appraisal' means any appraisal which is treated for purposes of this paragraph as a qualified appraisal under regulations or other guidance prescribed by the Secretary.

"(E) REGULATIONS OR OTHER GUIDANCE.—The Secretary shall prescribe such regulations or other guidance as may be necessary to carry out the purposes of this paragraph.".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to contributions made after June 3, 2004.

**SEC. 685. EXTENSION OF AMORTIZATION OF INTANGIBLES TO SPORTS FRANCHISES.**

(a) IN GENERAL.—Section 197(e) (relating to exceptions to definition of section 197 intangible) is amended by striking paragraph (6) and by redesignating paragraphs (7) and (8) as paragraphs (6) and (7), respectively.

(b) CONFORMING AMENDMENTS.—

(1)(A) Section 1056 (relating to basis limitation for player contracts transferred in connection with the sale of a franchise) is repealed.

(B) The table of sections for part IV of subchapter O of chapter 1 is amended by striking the item relating to section 1056.

(2) Section 1245(a) (relating to gain from disposition of certain depreciable property) is amended by striking paragraph (4).

(3) Section 1253 (relating to transfers of franchises, trademarks, and trade names) is amended by striking subsection (e).

(c) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to property acquired after the date of the enactment of this Act.

(2) SECTION 1245.—The amendment made by subsection (b)(2) shall apply to franchises acquired after the date of the enactment of this Act.

**SEC. 686. MODIFICATION OF CONTINUING LEVY ON PAYMENTS TO FEDERAL VENDERS.**

(a) IN GENERAL.—Section 6331(h) (relating to continuing levy on certain payments) is amended by adding at the end the following new paragraph:

"(3) INCREASE IN LEVY FOR CERTAIN PAYMENTS.—Paragraph (1) shall be applied by substituting '100 percent' for '15 percent' in the case of any specified payment due to a vendor of goods or services sold or leased to the Federal Government.".

(b) EFFECTIVE DATE.—The amendment made by this section shall take effect on the date of the enactment of this Act.

**SEC. 687. MODIFICATION OF STRADDLE RULES.**

(a) RULES RELATING TO IDENTIFIED STRADDLES.—

(1) IN GENERAL.—Subparagraph (A) of section 1092(a)(2) (relating to special rule for identified straddles) is amended to read as follows:

"(A) IN GENERAL.—In the case of any straddle which is an identified straddle—

"(i) paragraph (1) shall not apply with respect to identified positions comprising the identified straddle,

"(ii) if there is any loss with respect to any identified position of the identified straddle, the basis of each of the identified offsetting positions in the identified straddle shall be increased by an amount which bears the same ratio to the loss as the unrecognized gain with respect to such offsetting position bears to the aggregate unrecognized gain with respect to all such offsetting positions, and

"(iii) any loss described in clause (ii) shall not otherwise be taken into account for purposes of this title.".

(2) IDENTIFIED STRADDLE.—Section 1092(a)(2)(B) (defining identified straddle) is amended—

(A) by striking clause (ii) and inserting the following:

"(ii) to the extent provided by regulations, the value of each position of which (in the hands of the taxpayer immediately before the creation of the straddle) is not less than the basis of such position in the hands of the taxpayer at the time the straddle is created, and", and

(B) by adding at the end the following new flush sentence:

"The Secretary shall prescribe regulations which specify the proper methods for clearly identifying a straddle as an identified straddle (and the positions comprising such straddle), which specify the rules for the application of this section for a taxpayer which fails to properly identify the positions of an identified straddle, and which specify the ordering rules in cases where a taxpayer disposes of less than an entire position which is part of an identified straddle.".

(3) UNRECOGNIZED GAIN.—Section 1092(a)(3) (defining unrecognized gain) is amended by redesignating subparagraph (B) as subparagraph (C) and by inserting after subparagraph (A) the following new subparagraph:

"(B) SPECIAL RULE FOR IDENTIFIED STRADDLES.—For purposes of paragraph (2)(A)(ii), the unrecognized gain with respect to any identified offsetting position shall be the excess of the fair market value of the position at the time of the determination over the fair market value of the position at the time the taxpayer identified the position as a position in an identified straddle.".

(4) CONFORMING AMENDMENT.—Section 1092(c)(2) is amended by striking subparagraph (B) and by redesignating subparagraph (C) as subparagraph (B).

(b) PHYSICALLY SETTLED POSITIONS.—Section 1092(d) (relating to definitions and special rules) is amended by adding at the end the following new paragraph:

"(8) SPECIAL RULES FOR PHYSICALLY SETTLED POSITIONS.—For purposes of subsection (a), if a taxpayer settles a position which is part of a straddle by delivering property to which the position relates (and such position, if terminated, would result in a realization of a loss), then such taxpayer shall be treated as if such taxpayer—

"(A) terminated the position for its fair market value immediately before the settlement, and

"(B) sold the property so delivered by the taxpayer at its fair market value.".

(c) REPEAL OF STOCK EXCEPTION.—

(1) IN GENERAL.—Paragraph (3) of section 1092(d) (relating to definitions and special rules) is amended to read as follows:

"(3) SPECIAL RULES FOR STOCK.—For purposes of paragraph (1)—

"(A) IN GENERAL.—The term 'personal property' includes—

"(i) any stock which is a part of a straddle at least 1 of the offsetting positions of which is a position with respect to such stock or substantially similar or related property, or

"(ii) any stock of a corporation formed or availed of to take positions in personal property which offset positions taken by any shareholder.

"(B) RULE FOR APPLICATION.—For purposes of determining whether subsection (e) applies to any transaction with respect to stock described in sub-

paragraph (A)(ii), all includible corporations of an affiliated group (within the meaning of section 1504(a)) shall be treated as 1 taxpayer.".

(2) CONFORMING AMENDMENT.—Section 1258(d)(1) is amended by striking "; except that the term 'personal property' shall include stock".

(d) HOLDING PERIOD FOR DIVIDEND EXCLUSION.—The last sentence of section 246(c) is amended by inserting: ", other than a qualified covered call option to which section 1092(f) applies" before the period at the end.

(e) EFFECTIVE DATE.—The amendments made by this section shall apply to positions established on or after the date of the enactment of this Act.

**SEC. 688. ADDITION OF VACCINES AGAINST HEPATITIS A TO LIST OF TAXABLE VACCINES.**

(a) IN GENERAL.—Paragraph (1) of section 4132(a) (defining taxable vaccine) is amended by redesignating subparagraphs (I), (J), (K), and (L) as subparagraphs (J), (K), (L), and (M), respectively, and by inserting after subparagraph (H) the following new subparagraph:

"(I) Any vaccine against hepatitis A."

(b) EFFECTIVE DATE.—

(1) SALES, ETC.—The amendments made by subsection (a) shall apply to sales and uses on or after the first day of the first month which begins more than 4 weeks after the date of the enactment of this Act.

(2) DELIVERIES.—For purposes of paragraph (1) and section 4131 of the Internal Revenue Code of 1986, in the case of sales on or before the effective date described in such paragraph for which delivery is made after such date, the delivery date shall be considered the sale date.

**SEC. 689. ADDITION OF VACCINES AGAINST INFLUENZA TO LIST OF TAXABLE VACCINES.**

(a) IN GENERAL.—Section 4132(a)(1) (defining taxable vaccine), as amended by this Act, is amended by adding at the end the following new subparagraph:

"(N) Any trivalent vaccine against influenza.".

(b) EFFECTIVE DATE.—

(1) SALES, ETC.—The amendment made by this section shall apply to sales and uses on or after the later of—

(A) the first day of the first month which begins more than 4 weeks after the date of the enactment of this Act, or

(B) the date on which the Secretary of Health and Human Services lists any vaccine against influenza for purposes of compensation for any vaccine-related injury or death through the Vaccine Injury Compensation Trust Fund.

(2) DELIVERIES.—For purposes of paragraph (1) and section 4131 of the Internal Revenue Code of 1986, in the case of sales on or before the effective date described in such paragraph for which delivery is made after such date, the delivery date shall be considered the sale date.

**SEC. 690. EXTENSION OF IRS USER FEES.**

(a) IN GENERAL.—Section 7528(c) (relating to termination) is amended by striking "December 31, 2004" and inserting "September 30, 2014".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to requests after the date of the enactment of this Act.

**SEC. 691. COBRA FEES.**

(a) USE OF MERCHANDISE PROCESSING FEE.—Section 13031(f) of the Consolidated Omnibus Budget Reconciliation Act of 1985 (19 U.S.C. 58c(f)) is amended—

(1) in paragraph (1), by aligning subparagraph (B) with subparagraph (A); and

(2) in paragraph (2), by striking "commercial operations" and all that follows through "processing." and inserting "customs revenue functions as defined in section 415 of the Homeland Security Act of 2002 (other than functions performed by the Office of International Affairs referred to in section 415(8) of that Act), and for automation (including the Automation Commercial Environment computer system), and for no other purpose. To the extent that funds in the Customs User Fee Account are insufficient to pay the costs of such customs revenue functions, customs duties in an amount equal to the amount of such insufficiency shall be available, to the extent provided for in appropriations Acts, to pay the costs of such customs revenue functions in the amount of such insufficiency, and shall be available for no other purpose. The provisions of the first and second sentences of this paragraph specifying the purposes for which amounts in the Customs User Fee Account may be made available shall not be superseded except by a provision of law which specifically modifies or supersedes such provisions.".

(b) REIMBURSEMENT OF APPROPRIATIONS FROM COBRA FEES.—Section 13031(f)(3) of the Consolidated Omnibus Budget Reconciliation Act of 1985 (19 U.S.C. 58c(f)(3)) is amended by adding at the end the following:

"(E) Nothing in this paragraph shall be construed to preclude the use of appropriated funds, from sources other than the fees collected under subsection (a), to pay the costs set forth in clauses (i), (ii), and (iii) of subparagraph (A).".

(c) SENSE OF CONGRESS; EFFECTIVE PERIOD FOR COLLECTING FEES; STANDARD FOR SETTING FEES.—

(1) SENSE OF CONGRESS.—The Congress finds that—

(A) the fees set forth in paragraphs (1) through (8) of subsection (a) of section 13031 of the Consolidated Omnibus Budget Reconciliation Act of 1985 have been reasonably related to the costs of providing customs services in connection with the activities or items for which the fees have been charged under such paragraphs; and

(B) the fees collected under such paragraphs have not exceeded, in the aggregate, the amounts paid for the costs described in subsection (f)(3)(A) incurred in providing customs services in connection with the activities or items for which the fees were charged under such paragraphs.

(2) EFFECTIVE PERIOD; STANDARD FOR SETTING FEES.—Section 13031(j)(3) of the Consolidated Omnibus Budget Reconciliation Act of 1985 is amended to read as follows:

"(3)(A) Fees may not be charged under paragraphs (9) and (10) of subsection (a) after September 30, 2014.

"(B)(i) Subject to clause (ii), Fees may not be charged under paragraphs (1) through (8) of subsection (a) after September 30, 2014.

"(ii) In fiscal year 2006 and in each succeeding fiscal year for which fees under paragraphs (1) through (8) of subsection (a) are authorized—

"(I) the Secretary of the Treasury shall charge fees under each such paragraph in amounts that are reasonably related to the costs of providing customs services in connection with the activity or item for which the fee is charged under such paragraph, except that in no case may the fee charged under any such paragraph exceed by more than 10 percent the amount otherwise prescribed by such paragraph;

"(II) the amount of fees collected under such paragraphs may not exceed, in the aggregate, the amounts paid in that fiscal year for the costs described in subsection (f)(3)(A) incurred in providing customs services in connection with the activity or item for which the fees are charged under such paragraphs;

"(III) a fee may not be collected under any such paragraph except to the extent such fee will be expended to pay the costs described in subsection (f)(3)(A) incurred in providing customs services in connection with the activity or item for which the fee is charged under such paragraph; and

"(IV) any fee collected under any such paragraph shall be available for expenditure only to pay the costs described in subsection (f)(3)(A) incurred in providing customs services in connection with the activity or item for which the fee is charged under such paragraph.".

(d) CLERICAL AMENDMENTS.—Section 13031 of the Consolidated Omnibus Budget Reconciliation Act of 1985 is amended—

(1) in subsection (a)(5)(B), by striking "$1.75" and inserting "$1.75.";

(2) in subsection (b)—

(A) in paragraph (1)(A), by aligning clause (iii) with clause (ii);

(B) in paragraph (7), by striking "paragraphs" and inserting "paragraph"; and

(C) in paragraph (9), by aligning subparagraph (B) with subparagraph (A); and

(3) in subsection (e)(2), by aligning subparagraph (B) with subparagraph (A).

(e) STUDY OF ALL FEES COLLECTED BY DEPARTMENT OF HOMELAND SECURITY.—The Secretary of the Treasury shall conduct a study of all the fees collected by the Department of Homeland Security, and shall submit to the Congress, not later than September 30, 2005, a report containing the recommendations of the Secretary on—

(1) what fees should be eliminated;

(2) what the rate of fees retained should be; and

(3) any other recommendations with respect to the fees that the Secretary considers appropriate.

# TITLE VII—MARKET REFORM FOR TOBACCO GROWERS

**SEC. 701. SHORT TITLE.**

This title may be cited as the "Fair and Equitable Tobacco Reform Act of 2004".

**SEC. 702. EFFECTIVE DATE.**

This title and the amendments made by this title shall apply beginning with the 2005 marketing year of each kind of tobacco.

## Subtitle A—Termination of Federal Tobacco Quota and Price Support Programs

**SEC. 711. TERMINATION OF TOBACCO QUOTA PROGRAM AND RELATED PROVISIONS.**

(a) MARKETING QUOTAS.—Part I of subtitle B of title III of the Agricultural Adjustment Act of 1938 (7 U.S.C. 1311 et seq.) is repealed.

(b) PROCESSING.—Section 9(b) of the Agricultural Adjustment Act (7 U.S.C. 609(b)), reenacted with amendments by the Agricultural Marketing Agreement Act of 1937, is amended—

(1) in paragraph (2), by striking "tobacco,"; and

(2) in paragraph (6)(B)(i), by striking ", or, in the case of tobacco, is less than the fair exchange value by not more than 10 per centum,".

(c) DECLARATION OF POLICY.—Section 2 of the Agricultural Adjustment Act of 1938 (7 U.S.C. 1282) is amended by striking "tobacco,".

(d) DEFINITIONS.—Section 301(b) of the Agricultural Adjustment Act of 1938 (7 U.S.C. 1301(b)) is amended—

(1) in paragraph (3)—

(A) by striking subparagraph (C); and

(B) by redesignating subparagraph (D) as subparagraph (C);

(2) in paragraph (6)(A), by striking "tobacco,";

(3) in paragraph (10)—

(A) by striking subparagraph (B); and

(B) by redesignating subparagraph (C) as subparagraph (B);

(4) in paragraph (11)(B), by striking "and tobacco";

(5) in paragraph (12), by striking "tobacco,";

(6) in paragraph (14)—

(A) in subparagraph (A), by striking "(A)"; and

(B) by striking subparagraphs (B), (C), and (D);

(7) by striking paragraph (15);

(8) in paragraph (16)—

(A) by striking subparagraph (B); and

(B) by redesignating subparagraph (C) as subparagraph (B);

(9) by striking paragraph (17); and

(10) by redesignating paragraph (16) as paragraph (15).

(e) PARITY PAYMENTS.—Section 303 of the Agricultural Adjustment Act of 1938 (7 U.S.C. 1303) is amended in the first sentence by striking "rice, or tobacco," and inserting "or rice,".

(f) ADMINISTRATIVE PROVISIONS.—Section 361 of the Agricultural Adjustment Act of 1938 (7 U.S.C. 1361) is amended by striking "tobacco,".

(g) ADJUSTMENT OF QUOTAS.—Section 371 of the Agricultural Adjustment Act of 1938 (7 U.S.C. 1371) is amended—

(1) in the first sentence of subsection (a), by striking "rice, or tobacco" and inserting "or rice"; and

(2) in the first sentence of subsection (b), by striking "rice, or tobacco" and inserting "or rice".

(h) REGULATIONS.—Section 375 of the Agricultural Adjustment Act of 1938 (7 U.S.C. 1375) is amended—

(1) in subsection (a), by striking "peanuts, or tobacco" and inserting "or peanuts"; and

(2) by striking subsection (c).

(i) EMINENT DOMAIN.—Section 378 of the Agricultural Adjustment Act of 1938 (7 U.S.C. 1378) is amended—

(1) in the first sentence of subsection (c), by striking "cotton, and tobacco" and inserting "and cotton"; and

(2) by striking subsections (d), (e), and (f).

(j) BURLEY TOBACCO FARM RECONSTITUTION.—Section 379 of the Agricultural Adjustment Act of 1938 (7 U.S.C. 1379) is amended—

(1) in subsection (a)—

(A) by striking "(a)"; and

(B) in paragraph (6), by striking ", but this clause (6) shall not be applicable in the case of burley tobacco"; and

(2) by striking subsections (b) and (c).

(k) ACREAGE-POUNDAGE QUOTAS.—Section 4 of the Act of April 16, 1955 (Public Law 89–12; 7 U.S.C. 1314c note), is repealed.

(l) BURLEY TOBACCO ACREAGE ALLOTMENTS.—The Act of July 12, 1952 (7 U.S.C. 1315), is repealed.

(m) TRANSFER OF ALLOTMENTS.—Section 703 of the Food and Agriculture Act of 1965 (7 U.S.C. 1316) is repealed.

(n) ADVANCE RECOURSE LOANS.—Section 13(a)(2)(B) of the Food Security Improvements Act of 1986 (7 U.S.C. 1433c–1(a)(2)(B)) is amended by striking "tobacco and".

(o) TOBACCO FIELD MEASUREMENT.—Section 1112 of the Omnibus Budget Reconciliation Act of 1987 (Public Law 100–203) is amended by striking subsection (c).

**SEC. 712. TERMINATION OF TOBACCO PRICE SUPPORT PROGRAM AND RELATED PROVISIONS.**

(a) TERMINATION OF TOBACCO PRICE SUPPORT AND NO NET COST PROVISIONS.—Sections 106, 106A, and 106B of the Agricultural Act of 1949 (7 U.S.C. 1445, 1445–1, 1445–2) are repealed.

(b) PARITY PRICE SUPPORT.—Section 101 of the Agricultural Act of 1949 (7 U.S.C. 1441) is amended—

(1) in the first sentence of subsection (a), by striking "tobacco (except as otherwise provided herein), corn," and inserting "corn";

(2) by striking subsections (c), (g), (h), and (i);

(3) in subsection (d)(3)—

(A) by striking ", except tobacco,"; and

(B) by striking "and no price support shall be made available for any crop of tobacco for which marketing quotas have been disapproved by producers;"; and

(4) by redesignating subsections (d) and (e) as subsections (c) and (d), respectively.

(c) DEFINITION OF BASIC AGRICULTURAL COMMODITY.—Section 408(c) of the Agricultural Act of 1949 (7 U.S.C. 1428(c)) is amended by striking "tobacco,".

(d) POWERS OF COMMODITY CREDIT CORPORATION.—Section 5 of the Commodity Credit Corporation Charter Act (15 U.S.C. 714c) is amended by inserting "(other than tobacco)" after "agricultural commodities" each place it appears.

**SEC. 713. LIABILITY.**

The amendments made by this subtitle shall not affect the liability of any person under any provision of law so amended with respect to any crop of tobacco planted before the effective date of this Act.

## Subtitle B—Transitional Payments to Tobacco Quota Holders and Active Producers of Tobacco

**SEC. 721. DEFINITIONS OF ACTIVE TOBACCO PRODUCER AND QUOTA HOLDER.**

In this subtitle:

(1) ACTIVE TOBACCO PRODUCER.—The term "active tobacco producer" means an owner, operator, landlord, tenant, or sharecropper who—

(A) shared in the risk of producing tobacco on a farm where tobacco was produced or considered planted pursuant to a tobacco farm marketing quota or farm acreage allotment established under part I of subtitle B of title III of the Agricultural Adjustment Act of 1938 (7 U.S.C. 1311 et seq.) for the 2004 marketing year; and

(B) was actively engaged on that farm.

(2) CONSIDERED PLANTED.—The term "considered planted" means tobacco that was planted, but failed to be produced as a result of a natural disaster, as determined by the Secretary.

(3) TOBACCO QUOTA HOLDER.—The term "tobacco quota holder" means a person that was an owner of a farm, as of July 1, 2004, for which a basic tobacco farm marketing quota or farm acreage allotment for quota tobacco was established for the 2004 tobacco marketing year.

(4) SECRETARY.—The term "Secretary" means the Secretary of Agriculture.

**SEC. 722. PAYMENTS TO TOBACCO QUOTA HOLDERS.**

(a) PAYMENT REQUIRED.—The Secretary shall make payments to each eligible tobacco quota holder for the termination of tobacco marketing quotas and related price support under subtitle A, which shall constitute full and fair compensation for any losses relating to such termination.

(b) ELIGIBILITY.—To be eligible to receive a payment under this section, a person shall submit to the Secretary an application containing such information as the Secretary may require to demonstrate to the satisfaction of the Secretary that the person satisfies the definition of tobacco quota holder. The application shall be submitted within such time, in such form, and in such manner as the Secretary may require.

(c) INDIVIDUAL BASE QUOTA LEVEL.—

(1) IN GENERAL.—The Secretary shall establish a base quota level applicable to each eligible tobacco quota holder identified under subsection (b).

(2) POUNDAGE QUOTAS.—Subject to adjustment under subsection (d), for each kind of tobacco for which the marketing quota is expressed in pounds, the base quota level for each tobacco quota holder shall be equal to the basic tobacco marketing quota under the Agriculture Adjustment Act of 1938 for the marketing year in effect on the date of the enactment of this Act for quota tobacco on the farm owned by the tobacco quota holder.

(3) MARKETING QUOTAS OTHER THAN POUNDAGE QUOTAS.—Subject to adjustment under subsection (d), for each kind of tobacco for which there is marketing quota or allotment on an acreage basis, the base quota level for each tobacco quota holder shall be the amount equal to the product obtained by multiplying—

(A) the basic tobacco farm marketing quota or allotment for the marketing year in effect on the date of the enactment of this Act, as established by the Secretary for quota tobacco on the farm owned by the tobacco quota holder; by

(B) the average county production yield per acre for the county in which the farm is located for the kind of tobacco for that marketing year.

(d) TREATMENT OF CERTAIN CONTRACTS AND AGREEMENTS.—

(1) EFFECT OF PURCHASE CONTRACT.—If there was an agreement for the purchase of all or part of a farm described in subsection (c) as of the date of the enactment of this Act, and the parties to the sale are unable to agree to the disposition of eligibility for payments under this section, the Secretary, taking into account any transfer of quota that has been agreed to, shall provide for the equitable division of the payments among the parties by adjusting the determination of who is the tobacco quota holder with respect to particular pounds of the quota.

(2) EFFECT OF AGREEMENT FOR PERMANENT QUOTA TRANSFER.—If the Secretary determines that there was in existence, as of the day before the date of the enactment of this Act, an agreement for the permanent transfer of quota, but that the transfer was not completed by that date, the Secretary shall consider the tobacco quota holder to be the party to the agreement that, as of that date, was the owner of the farm to which the quota was to be transferred.

(e) TOTAL PAYMENT AMOUNTS BASED ON 2002 MARKETING YEAR.—

(1) CALCULATION OF ANNUAL PAYMENT AMOUNT.—During fiscal years 2005 through 2009, the Secretary shall make payments to all eligible tobacco quota holders identified under subsection (b) in an annual amount equal to the product obtained by multiplying, for each kind of tobacco—

(A) $1.40 per pound; by

(B) the total national basic marketing quota established under the Agriculture Adjustment Act of 1938 for the 2002 marketing year for that kind of tobacco.

(2) MARKETING QUOTAS OTHER THAN POUNDAGE QUOTAS.—For each kind of tobacco for which there is a marketing quota or allotment on an acreage basis, the Secretary shall convert the tobacco farm marketing quotas or allotments established under the Agriculture Adjustment Act of 1938 for the 2002 marketing year for that kind of tobacco as the Secretary considers appropriate.

(f) INDIVIDUAL PAYMENT AMOUNTS.—The annual payment amount for each eligible tobacco quota holder with respect to a kind of tobacco under this section shall bear the same ratio to the amount determined by the Secretary under subsection (e) with respect to that kind of tobacco as the individual base quota level of that eligible tobacco quota holder under subsection (c) with respect to that kind of tobacco bears to the total base quota levels of all eligible tobacco quota holders with respect to that kind of tobacco.

(g) DEATH OF TOBACCO QUOTA HOLDER.—If a tobacco quota holder who is entitled to payments under this section dies and is survived by a spouse or one or more de-

pendents, the right to receive the payments shall transfer to the surviving spouse or, if there is no surviving spouse, to the estate of the tobacco quota holder.

**SEC. 723. TRANSITION PAYMENTS FOR ACTIVE PRODUCERS OF QUOTA TOBACCO.**

(a) TRANSITION PAYMENTS REQUIRED.—The Secretary shall make transition payments under this section to eligible active producers of quota tobacco.

(b) ELIGIBILITY.—To be eligible to receive a transition payment under this section, a person shall submit to the Secretary an application containing such information as the Secretary may require to demonstrate to the satisfaction of the Secretary that the person satisfies the definition of active producer of quota tobacco. The application shall be submitted within such time, in such form, and in such manner as the Secretary may require.

(c) CURRENT PRODUCTION BASE.—The Secretary shall establish a production base applicable to each eligible active producer of quota tobacco identified under subsection (b). A producer's production base shall be equal to the quantity, in pounds, of quota tobacco subject to the basic marketing quota marketed or considered planted by the producer under the Agriculture Adjustment Act of 1938 for the marketing year in effect on the date of the enactment of this Act.

(d) TOTAL PAYMENT AMOUNTS BASED ON 2002 MARKETING YEAR.—

(1) CALCULATION OF ANNUAL PAYMENT AMOUNT.—During fiscal years 2005 through 2009, the Secretary shall make payments to all eligible active producers of quota tobacco identified under subsection (b) in an annual amount equal to the product obtained by multiplying, for each kind of tobacco—

(A) $0.60 per pound; by

(B) the total national effective marketing quota established under the Agriculture Adjustment Act of 1938 for the 2002 marketing year for that kind of tobacco.

(2) MARKETING QUOTAS OTHER THAN POUNDAGE QUOTAS.—For each kind of tobacco for which there is a marketing quota or allotment on an acreage basis, the Secretary shall convert the tobacco farm marketing quotas or allotments established under the Agriculture Adjustment Act of 1938 for the 2002 marketing year for that kind of tobacco to a poundage basis before executing the mathematical equation specified in paragraph (1).

(e) INDIVIDUAL PAYMENT AMOUNTS.—The annual payment amount for each eligible active producer of quota tobacco identified under subsection (b) with respect to a kind of tobacco under this section shall bear the same ratio to the amount determined by the Secretary under subsection (d) with respect to that kind of tobacco as the individual production base of that eligible active producer under subsection (c) with respect to that kind of tobacco bears to the total production bases determined under that subsection for all eligible active producers of that kind of tobacco.

(f) DEATH OF TOBACCO PRODUCER.—If a tobacco producer who is entitled to payments under this section dies and is survived by a spouse or one or more dependents, the right to receive the payments shall transfer to the surviving spouse or, if there is no surviving spouse, to the estate of the tobacco producer.

**SEC. 724. RESOLUTION OF DISPUTES.**

Any dispute regarding the eligibility of a person to receive a payment under this subtitle, or the amount of the payment, shall be resolved by the county committee established under section 8 of the Soil Conservation and Domestic Allotment Act (16 U.S.C. 590h) for the county or other area in which the farming operation of the person is located.

**SEC. 725. SOURCE OF FUNDS FOR PAYMENTS.**

There is hereby appropriated to the Secretary, from amounts in the general fund of the Treasury, such amounts as the Secretary needs in order to make the payments required by sections 722 and 723, except that such amounts shall not exceed the lesser of—

(1) amounts received in the Treasury under chapter 52 of the Internal Revenue Code of 1986 (relating to tobacco products and cigarette papers and tubes), or

(2) $9,600,000,000.

# TITLE VIII—TRADE PROVISIONS

**SEC. 801. CEILING FANS.**

(a) IN GENERAL.—Subchapter II of chapter 99 of the Harmonized Tariff Schedule of the United States is amended by inserting in numerical sequence the following new heading:

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| " | 9902.84.14 | Ceiling fans for permanent installation (provided for in subheading 8414.51.00) ..... | Free | No change | No change | On or before 12/31/2006 | ". |

(b) EFFECTIVE DATE.—The amendment made by this section applies to goods entered, or withdrawn from warehouse, for consumption on or after the 15th day after the date of enactment of this Act.

**SEC. 802. CERTAIN STEAM GENERATORS, AND CERTAIN REACTOR VESSEL HEADS, USED IN NUCLEAR FACILITIES.**

(a) CERTAIN STEAM GENERATORS.—Heading 9902.84.02 of the Harmonized Tariff Schedule of the United States is amended by striking "12/31/2006" and inserting "12/31/2008".

(b) CERTAIN REACTOR VESSEL HEADS.—Subchapter II of chapter 99 of the Harmonized Tariff Schedule of the United States is amended by inserting in numerical sequence the following new heading:

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| " | 9902.84.03 | Reactor vessel heads for nuclear reactors (provided for in subheading 8401.40.00) | Free | No change | No change | On or before 12/31/2008 | ". |

(c) EFFECTIVE DATE.—

(1) SUBSECTION (a).—The amendment made by subsection (a) shall take effect on the date of the enactment of this Act.

(2) SUBSECTION (b).—The amendment made by subsection (b) shall apply to goods entered, or withdrawn from warehouse, for consumption on or after the 15th day after the date of the enactment of this Act.

# I. SUMMARY AND BACKGROUND

## A. PURPOSE AND SUMMARY

The bill, H.R. 4520, as amended, (the "American Jobs Creation Act of 2004") repeals the exclusion for extraterritorial income (the "ETI" regime) and provides a reduced corporate income tax rate for domestic production activities and other corporate reform and growth incentives.

The bill provides net tax reductions of over $21.136 billion over fiscal years 2004–2008.

## B. BACKGROUND AND NEED FOR LEGISLATION

The provisions approved by the Committee comply with the World Trade Organization holding that the ETI regime constitutes a prohibited export subsidy under the relevant trade agreements. The provisions approved by the Committee provide other corporate reform and growth incentives. The estimated revenue effects of the provisions comply with the most recent Congressional Budget Office revisions of budget projections.

## C. LEGISLATIVE HISTORY

The Committee on Ways and Means marked up the American Jobs Creation Act of 2004 on June 14, 2004, and ordered the bill, as amended, favorably reported by a roll call vote of 27 yeas and 9 nays (with a quorum being present).

# TITLE I—END SANCTIONS AND REDUCE CORPORATE TAX RATES FOR DOMESTIC MANUFACTURING AND SMALL CORPORATIONS

## A. REPEAL OF EXCLUSION FOR EXTRATERRITORIAL INCOME

(Sec. 101 of the bill and secs. 114 and 941–943 of the Code)[1]

### PRESENT LAW

The United States has long provided export-related benefits under a series of tax regimes, including the domestic international sales corporation ("DISC") regime, the foreign sales corporation ("FSC") regime, and the extraterritorial income ("ETI") regime. Each of these regimes has been found to violate U.S. obligations under international trade agreements. In 2000, the European Union ("EU") succeeded in having the FSC regime declared a prohibited export subsidy by the WTO. In response to this WTO ruling, the United States repealed the FSC rules and enacted a new regime under the FSC Repeal and Extraterritorial Income Exclusion Act of 2000. The EU immediately challenged the ETI regime in the WTO, and in January of 2002 a WTO Appellate Body held that the ETI regime also constituted a prohibited export subsidy under the relevant trade agreements.

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

Foreign trading gross receipts are gross receipts derived from certain activities in connection with "qualifying foreign trade property" with respect to which certain economic processes take place outside of the United States. Specifically, the gross receipts must be: (1) from the sale, exchange, or other disposition of qualifying foreign trade property; (2) from the lease or rental of qualifying foreign trade property for use by the lessee outside the United States; (3) for services which are related and subsidiary to the sale, exchange, disposition, lease, or rental of qualifying foreign trade property (as described above); (4) for engineering or architectural services for construction projects located outside the United States; or (5) for the performance of certain managerial services for unrelated persons. A taxpayer may elect to treat gross receipts from a

[1] Section references are to the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise indicated.

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

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

transaction as not foreign trading gross receipts. As a result of such an election, a taxpayer may use any related foreign tax credits in lieu of the exclusion.

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

REASONS FOR CHANGE

The Committee believes it is important that the United States, and all members of the WTO, comply with WTO decisions and honor their obligations under WTO agreements. Therefore, the Committee believes that the ETI regime should be repealed. The Committee believes that it is necessary and appropriate to provide transition relief comparable to that which has been included in the past in measures taken by WTO members to bring their laws into compliance with WTO decisions and obligations.

The Committee also believes that it is important to use the opportunity afforded by the repeal of the ETI regime to reform the U.S. tax system in a manner that makes U.S. businesses and workers more productive and competitive than they are today. To this end, the Committee believes that it is important to provide tax cuts to U.S. domestic manufacturers and to update the U.S. international tax rules, which are over 40 years old and make U.S. companies uncompetitive in the United States and abroad.

EXPLANATION OF PROVISION

The provision repeals the ETI exclusion. For transactions prior to 2005, taxpayers retain 100 percent of their ETI benefits. For transactions after 2004, the provision provides taxpayers with 80 percent of their otherwise-applicable ETI benefits for transactions during 2005 and 60 percent of their otherwise-applicable ETI benefits for transactions during 2006. However, the provision provides that the ETI exclusion provisions remain in effect for transactions in the ordinary course of a trade or business if such transactions are pursuant to a binding contract[4] between the taxpayer and an unrelated person and such contract is in effect on January 14, 2002, and at all times thereafter.

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

[4] This rule also applies to a purchase option, renewal option, or replacement option that is included in such contract and that is enforceable against the sellor or lessor. For this purpose, a replacement option will be considered enforceable against a lessor notwithstanding the fact that a lessor retained approval of the replacement lessee.

EFFECTIVE DATE

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

## B. Reduced Corporate Income Tax Rate for Domestic Production Activities Income

(Sec. 102 of the bill and sec. 11 of the Code)

PRESENT LAW

A corporation's regular income tax liability is determined by applying the following tax rate schedule to its taxable income.

TABLE 1.—MARGINAL FEDERAL CORPORATE INCOME TAX RATES FOR 2004

[Percent of taxable income]

| Taxable income | Income tax rate |
|---|---|
| $0–$50,000 | 15 |
| $50,001–$75,000 | 25 |
| $75,001–$10,000,000 | 34 |
| Over $10,000,000 | 35 |

The benefit of the first two graduated rates described above is phased out by a five-percent surcharge for corporations with taxable income between $100,000 and $335,000. Also, the benefit of the 34–percent rate is phased out by a three-percent surcharge for corporations with taxable income between $15 million and $18,333,333; a corporation with taxable income of $18,333,333 or more effectively is subject to a flat rate of 35 percent.

Under present law, there is no provision that reduces the corporate income tax for taxable income attributable to domestic production activities.

REASONS FOR CHANGE

The Committee believes that creating new jobs is an essential element of economic recovery and expansion, and that tax policies designed to foster economic strength also will contribute to the continuation of the recent increases in employment levels. To accomplish this objective, the Committee believes that Congress should enact tax laws that enhance the ability of domestic businesses, and domestic manufacturing firms in particular, to compete in the global marketplace.

The Committee believes that a reduced tax burden on domestic manufacturers will improve the cash flow of domestic manufacturers and make investments in domestic manufacturing facilities more attractive. Such investment will create and preserve U.S. manufacturing jobs.

EXPLANATION OF PROVISION

*In general*

The bill provides that the corporate tax rate applicable to qualified production activities income may not exceed 32 percent (34 percent for taxable years beginning before 2007) of the qualified production activities income.

*Qualified production activities income*

"Qualified production activities income" is the income attributable to domestic production gross receipts, reduced by the sum of: (1) the costs of goods sold that are allocable to such receipts; (2) other deductions, expenses, or losses that are directly allocable to such receipts; and (3) a proper share of other deductions, expenses, and losses that are not directly allocable to such receipts or another class of income.[5]

*Domestic production gross receipts*

"Domestic production gross receipts" generally are gross receipts of a corporation that are derived from: (1) any sale, exchange or other disposition, or any lease, rental or license, of qualifying production property that was manufactured, produced, grown or extracted (in whole or in significant part) by the corporation within the United States;[6] (2) any sale, exchange or other disposition, or any lease, rental or license, of qualified film produced by the taxpayer; or (3) construction, engineering or architectural services performed in the United States for construction projects located in the United States. However, domestic production gross receipts do not include any gross receipts of the taxpayer derived from property that is leased, licensed or rented by the taxpayer for use by any related person.[7]

"Qualifying production property" generally is any tangible personal property, computer software, or property described in section 168(f)(4) of the Code. "Qualified film" is any property described in section 168(f)(3) of the Code (other than certain sexually explicit productions) if 50 percent or more of the total compensation relating to the production of such film (other than compensation in the form of residuals and participations) constitutes compensation for services performed in the United States by actors, production personnel, directors, and producers.

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

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

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

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

EFFECTIVE DATE

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

## C. Reduced Corporate Income Tax Rate for Small Corporations

(Sec. 103 of the bill and sec. 11 of the Code)

PRESENT LAW

A corporation's regular income tax liability is determined by applying the following tax rate schedule to its taxable income.

Table 1.—MARGINAL FEDERAL CORPORATE INCOME TAX RATES FOR 2004

[Percent of taxable income]

| Taxable income | Income tax rate |
|---|---|
| $0–$50,000 | 15 |
| $50,001–$75,000 | 25 |
| $75,001–$10,000,000 | 34 |
| Over $10,000,000 | 35 |

The benefit of the first two graduated rates described above is phased out by a five-percent surcharge for corporations with taxable income between $100,000 and $335,000. Also, benefit of the 34–percent rate is phased out by a three-percent surcharge for corporations with taxable income between $15 million and $18,333,333; a corporation with taxable income of $18,333,333 or more effectively is subject to a flat rate of 35 percent.

REASONS FOR CHANGE

The Committee believes that reducing the tax burden on small and medium sized businesses will enable them to continue to create and maintain new jobs in the United States. A reduced tax burden on smaller businesses simultaneously makes investments by small businesses more attractive and improves the cash flow of such businesses, thus facilitating the financing of investments. New investment by small business is responsible for substantial job creation in the economy and provides the foundation for new industries, new technology, and the future of the U. S. economy.

EXPLANATION OF PROVISION

Under the provision, a corporation's regular income tax liability is determined by applying the following tax rate schedules to its taxable income.

TABLE 2.—MARGINAL FEDERAL CORPORATE INCOME TAX RATES FOR 2013 AND THEREAFTER

[Percent of taxable income]

| Taxable income | Income tax rate |
|---|---|
| $0–$50,000 | 15 |
| $50,001–$75,000 | 25 |
| $75,001–$20,000,000 | 32 |
| Over $20,000,000 | 35 |

The benefit of the graduated rates described above is phased out by a three-percent surcharge for corporations with taxable income between $20 million and $40,341,667; a corporation with taxable income of $40,341,667 or more effectively is subject to a flat rate of 35 percent.

TABLE 3.—MARGINAL FEDERAL CORPORATE INCOME TAX RATES FOR 2011–2012

[Percent of taxable income]

| Taxable income | Income tax rate |
|---|---|
| $0–$50,000 | 15 |
| $50,001–$75,000 | 25 |
| $75,001–$5,000,000 | 32 |
| $5,000,001–$10,000,000 | 34 |
| Over $10,000,000 | 35 |

The benefit of the first three graduated rates described above is phased out by a five-percent surcharge for corporations with taxable income between $5,000,000 and $7,205,000. Also, the benefit of the 34-percent rate is phased out by a three-percent surcharge for corporations with taxable income between $15 million and $18,333,333; a corporation with taxable income of $18,333,333 or more effectively is subject to a flat rate of 35 percent.

TABLE 4.—MARGINAL FEDERAL CORPORATE INCOME TAX RATES FOR 2008–2010

[Percent of taxable income]

| Taxable income | Income tax rate |
|---|---|
| $0–$50,000 | 15 |
| $50,001–$75,000 | 25 |
| $75,001–$1,000,000 | 32 |
| $1,000,001–$10,000,000 | 34 |
| Over $10,000,000 | 35 |

The benefit of the first three graduated rates described above is phased out by a five-percent surcharge for corporations with taxable income between $1,000,000 and $1,605,000. Also, the benefit of the 34-percent rate is phased out by a three-percent surcharge for corporations with taxable income between $15 million and $18,333,333; a corporation with taxable income of $18,333,333 or more effectively is subject to a flat rate of 35 percent.

TABLE 5.—MARGINAL FEDERAL CORPORATE INCOME TAX RATES FOR 2005–2007

[Percent of taxable income]

| Taxable income | Income tax rate |
|---|---|
| $0–$50,000 | 15 |
| $50,001–$75,000 | 25 |
| $75,001–$1,000,000 | 33 |
| $1,000,001–$10,000,000 | 34 |
| Over $10,000,000 | 35 |

The benefit of the first three graduated rates described above is phased out by a five-percent surcharge for corporations with taxable income between $1,000,000 and $1,420,000. Also, the benefit of the 34-percent rate is phased out by a three-percent surcharge

for corporations with taxable income between $15 million and $18,333,333; a corporation with taxable income of $18,333,333 or more effectively is subject to a flat rate of 35 percent.

EFFECTIVE DATE

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

## TITLE II—CORPORATE REFORM AND GROWTH INCENTIVES FOR MANUFACTURERS, SMALL BUSINESSES, AND FARMERS

### A. SMALL BUSINESS EXPENSING

#### 1. Extension of increased section 179 expensing (sec. 201 of the bill and sec. 179 of the Code)

PRESENT LAW

Present law provides that, in lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct such costs. The Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) of 2003[8] increased the amount a taxpayer may deduct, for taxable years beginning in 2003 through 2005, to $100,000 of the cost of qualifying property placed in service for the taxable year.[9] In general, qualifying property is defined as depreciable tangible personal property (and certain computer software) that is purchased for use in the active conduct of a trade or business. The $100,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $400,000. The $100,000 and $400,000 amounts are indexed for inflation.

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

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

Under present law, an expensing election is made under rules prescribed by the Secretary.[10] Applicable Treasury regulations pro-

[8] Pub. L. No. 108–27, sec. 202 (2003).

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

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

vide that an expensing election generally is made on the taxpayer's original return for the taxable year to which the election relates.[11]

Prior to the enactment of JGTRRA (and for taxable years beginning in 2006 and thereafter), an expensing election may be revoked only with consent of the Commissioner.[12] JGTRRA permits taxpayers to revoke expensing elections on amended returns without the consent of the Commissioner with respect to a taxable year beginning after 2002 and before 2006.[13]

REASONS FOR CHANGE

The Committee believes that section 179 expensing provides two important benefits for small businesses. First, it lowers the cost of capital for property used in a trade or business. With a lower cost of capital, the Committee believes small businesses will invest in more equipment and employ more workers. Second, it eliminates depreciation recordkeeping requirements with respect to expensed property. In JGTRRA, Congress acted to increase the value of these benefits and to increase the number of taxpayers eligible for taxable years through 2005. The Committee believes that these changes to section 179 expensing will continue to provide important benefits if extended, and the bill therefore extends these changes for an additional two years.

EXPLANATION OF PROVISION

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

EFFECTIVE DATE

The provision is effective on the date of enactment.

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[11] Treas. Reg. sec. 1.179–5. Under these regulations, a taxpayer may make the election on the original return (whether or not the return is timely), or on an amended return filed by the due date (including extensions) for filing the return for the tax year the property was placed in service. If the taxpayer timely filed an original return without making the election, the taxpayer may still make the election by filing an amended return within six months of the due date of the return (excluding extensions).

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

[13] Id.

## B. Depreciation

### 1. Recovery period for depreciation of certain leasehold improvements and restaurant property (sec. 211 of the bill and sec. 168 of the Code)

#### PRESENT LAW

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the modified accelerated cost recovery system ("MACRS"), which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property (sec. 168). The cost of nonresidential real property is recovered using the straight-line method of depreciation and a recovery period of 39 years. Nonresidential real property is subject to the mid-month placed-in-service convention. Under the mid-month convention, the depreciation allowance for the first year property is placed in service is based on the number of months the property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month.

*Depreciation of leasehold improvements*

Depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease (sec. 168(i)(8)).[14] This rule applies regardless of whether the lessor or the lessee places the leasehold improvements in service.[15] If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement was placed in service (secs. 168(b)(3), (c), (d)(2), and (i)(6)).[16]

*Qualified leasehold improvement property*

The Job Creation and Worker Assistance Act of 2002[17] ("JCWAA"), as amended by JGTRRA, generally provides an additional first-year depreciation deduction equal to either 30 percent or 50 percent of the adjusted basis of qualified property placed in

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

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

[16] If the improvement is characterized as tangible personal property, ACRS or MACRS depreciation is calculated using the shorter recovery periods, accelerated methods, and conventions applicable to such property. The determination of whether improvements are characterized as tangible personal property or as nonresidential real property often depends on whether or not the improvements constitute a "structural component" of a building (as defined by Treas. Reg. sec. 1.48–1(e)(1)). *See, e.g., Metro National Corp* v. *Commissioner*, 52 TCM (CCH) 1440 (1987); *King Radio Corp Inc.* v. *U.S.*, 486 F.2d 1091 (10th Cir. 1973); *Mallinckrodt, Inc.* v. *Commissioner*, 778 F.2d 402 (8th Cir. 1985) (with respect to various leasehold improvements).

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

service before January 1, 2005. Qualified property includes qualified leasehold improvement property. For this purpose, qualified leasehold improvement property is any improvement to an interior portion of a building that is nonresidential real property, provided certain requirements are met. The improvement must be made under or pursuant to a lease either by the lessee (or sublessee), or by the lessor, of that portion of the building to be occupied exclusively by the lessee (or sublessee). The improvement must be placed in service more than three years after the date the building was first placed in service. Qualified leasehold improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building.

*Treatment of dispositions of leasehold improvements*

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

REASONS FOR CHANGE

The Committee believes that taxpayers should not be required to recover the costs of certain leasehold improvements beyond the useful life of the investment. The present law 39-year recovery period for leasehold improvements extends well beyond the useful life of such investments. Although lease terms differ, the Committee believes that lease terms for commercial real estate typically are shorter than the present-law 39-year recovery period. In the interests of simplicity and administrability, a uniform period for recovery of leasehold improvements is desirable. The Committee bill therefore shortens the recovery period for leasehold improvements to a more realistic 15 years.

The Committee also believes that unlike other commercial buildings, restaurant buildings generally are more specialized structures. Restaurants also experience considerably more traffic, and remain open longer than most retail properties. This daily assault causes rapid deterioration of restaurant properties and forces restaurateurs to constantly repair and upgrade their facilities. As such, restaurant facilities have a much shorter life span than other commercial establishments. The Committee bill reduces the 39-year recovery period for improvements made to restaurant buildings and more accurately reflects the true economic life of the properties by reducing the recovery period to 15 years.

EXPLANATION OF PROVISION

The provision provides a statutory 15-year recovery period for qualified leasehold improvement property placed in service before

January 1, 2006.[18] The provision requires that qualified leasehold improvement property be recovered using the straight-line method.

Qualified leasehold improvement property is defined as under present law for purposes of the additional first-year depreciation deduction (sec. 168(k)), with the following modification. If a lessor makes an improvement that qualifies as qualified leasehold improvement property such improvement shall not qualify as qualified leasehold improvement property to any subsequent owner of such improvement. An exception to the rule applies in the case of death and certain transfers of property that qualify for non-recognition treatment.

The provision also provides a statutory 15-year recovery period for qualified restaurant property placed in service before January 1, 2006.[19] For purposes of the provision, qualified restaurant property means any improvement to a building if such improvement is placed in service more than three years after the date such building was first placed in service and more than 50 percent of the building's square footage is devoted to the preparation of, and seating for, on-premises consumption of prepared meals. The provision requires that qualified restaurant property be recovered using the straight-line method.

EFFECTIVE DATE

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

2. Modification of depreciation allowance for aircraft (sec. 212 of the bill and sec. 168 of the Code)

PRESENT LAW

*In general*

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

*Thirty-percent additional first year depreciation deduction*

JCWAA allows an additional first-year depreciation deduction equal to 30 percent of the adjusted basis of qualified property.[20]

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

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

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

The amount of the additional first-year depreciation deduction is not affected by a short taxable year. The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service.[21] The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, there are generally no adjustments to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to property to which the provision applies. A taxpayer is allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.[22]

In order for property to qualify for the additional first-year depreciation deduction, it must meet all of the following requirements. First, the property must be (1) property to which MACRS applies with an applicable recovery period of 20 years or less, (2) water utility property (as defined in section 168(e)(5)), (3) computer software other than computer software covered by section 197, or (4) qualified leasehold improvement property (as defined in section 168(k)(3)).[23] Second, the original use[24] of the property must commence with the taxpayer on or after September 11, 2001. Third, the taxpayer must acquire the property within the applicable time period. Finally, the property must be placed in service before January 1, 2005.

An extension of the placed-in-service date of one year (i.e., January 1, 2006) is provided for certain property with a recovery period of ten years or longer and certain transportation property.[25] Transportation property is defined as tangible personal property used in the trade or business of transporting persons or property.

The applicable time period for acquired property is (1) after September 10, 2001 and before January 1, 2005, but only if no binding written contract for the acquisition is in effect before September 11, 2001, or (2) pursuant to a binding written contract which was entered into after September 10, 2001, and before January 1, 2005.[26] For property eligible for the extended placed-in-service date, a special rule limits the amount of costs eligible for the additional first year depreciation. With respect to such property, only the portion of the basis that is properly attributable to the costs incurred be-

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

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

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

[24] The term "original use" means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. If, in the normal course of its business, a taxpayer sells fractional interests in property to unrelated third parties, then the original use of such property begins with the first user of each fractional interest (i.e., each fractional owner is considered the original user of its proportionate share of the property).

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

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

fore January 1, 2005 ("progress expenditures") is eligible for the additional first-year depreciation.[27]

*Fifty-percent additional first year depreciation*

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

In order to qualify, the property must be acquired after May 5, 2003, and before January 1, 2005, and no binding written contract for the acquisition can be in effect before May 6, 2003.[28] With respect to property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property after May 5, 2003. For property eligible for the extended placed-in-service date (i.e., certain property with a recovery period of ten years or longer and certain transportation property), a special rule limits the amount of costs eligible for the additional first-year depreciation. With respect to such property, only progress expenditures properly attributable to the costs incurred before January 1, 2005 are eligible for the additional first-year depreciation.[29]

REASONS FOR CHANGE

The Committee believes that certain non-commercial aircraft represent property having characteristics that should qualify for the extended placed-in-service date accorded under present law for property having long production periods. This treatment should be available only if the purchaser makes a substantial deposit, the expected cost exceeds certain thresholds, and the production period is sufficiently long.

EXPLANATION OF PROVISION

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

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

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

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

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

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

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

(d) Be purchased[30] by a purchaser who, at the time of the contract for purchase, has made a nonrefundable deposit of the lesser of ten percent of the cost or $100,000; and

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

EFFECTIVE DATE

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

3. Modification of placed in service rule for bonus depreciation property (sec. 213 of the bill and sec. 168 of the Code)

PRESENT LAW

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

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

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

in effect before May 6, 2003. With respect to property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property after May 5, 2003.

REASONS FOR CHANGE

The Committee believes that the rules relating to 30-percent additional first-year depreciation should be clarified to reflect the legislative intent that syndicated property, if sold within three months of the date it was originally placed in service, be eligible for the additional first-year depreciation deduction. Further, the Committee is aware that certain syndication arrangements are entered into with respect to multiple units of property (such as rail cars) that, for logistical reasons, must be placed in service over a period of time that exceeds three months. In such cases, it would be impractical for the sale of the earlier produced units to occur within three months of its placed-in-service date. Thus, the Committee deems it appropriate to provide a special rule with respect to the syndication of multiple units of property that will be placed in service over a period of up to twelve months.

EXPLANATION OF PROVISION

The provision provides that if property is originally placed in service by a lessor (including by operation of the special rule for self-constructed property), such property is sold within three months after the date that the property was placed in service, and the user of such property does not change, then the property is treated as originally placed in service by the taxpayer not earlier than the date of such sale. The provision also provides a special rule in the case of multiple units of property subject to the same lease. In such cases, property will qualify as placed in service on the date of sale if it is sold within three months after the final unit is placed in service, so long as the period between the time the first and last units are placed in service does not exceed 12 months.

EFFECTIVE DATE

The provision is generally effective as if included in the amendments made by section 101 of JCWAA (i.e., generally for property placed in service after September 10, 2001, in taxable years ending after that date). However, the special rule in the case of multiple units of property subject to the same lease applies to property sold after June 4, 2004.

## C. S Corporation Reform and Simplification

(Secs. 221–231 of the bill and secs. 1361–1379 and 4975 of the Code)

OVERVIEW

In general, an S corporation is not subject to corporate-level income tax on its items of income and loss. Instead, an S corporation passes through its items of income and loss to its shareholders. The shareholders take into account separately their shares of these items on their individual income tax returns. To prevent double taxation of these items when the stock is later disposed of, each

shareholder's basis in the stock of the S corporation is increased by the amount included in income (including tax-exempt income) and is decreased by the amount of any losses (including nondeductible losses) taken into account. A shareholder's loss may be deducted only to the extent of his or her basis in the stock or debt of the S corporation. To the extent a loss is not allowed due to this limitation, the loss generally is carried forward with respect to the shareholder.

REASONS FOR CHANGE

The bill contains a number of general provisions relating to S corporations. The Committee adopted these provisions that modernize the S corporation rules and eliminate undue restrictions on S corporations in order to expand the application of the S corporation provisions so that more corporations and their shareholders will be able to enjoy the benefits of subchapter S status.

The Committee is aware of obstacles that have prevented banks from electing subchapter S status.[31] The bill contains provisions that apply specifically to banks in order to remove these obstacles and make S corporation status more readily available to banks.

The bill also revises the prohibited transaction rules applicable to employee stock ownership plans ("ESOPs") maintained by S corporations in order to expand the ability to use distributions made with respect to S corporation stock held by an ESOP to repay a loan used to purchase the stock, subject to the same conditions that apply to C corporation dividends used to repay such a loan.

1. Members of family treated as one shareholder; increase in number of eligible shareholders to 100

PRESENT LAW

A small business corporation may elect to be an S corporation with the consent of all its shareholders, and may terminate its election with the consent of shareholders holding more than 50 percent of the stock. A "small business corporation" is defined as a domestic corporation which is not an ineligible corporation and which has (1) no more than 75 shareholders, all of whom are individuals (and certain trusts, estates, charities, and qualified retirement plans)[32] who are citizens or residents of the United States, and (2) only one class of stock. For purposes of the 75-shareholder limitation, a husband and wife are treated as one shareholder. An "ineligible corporation" means a corporation that is a financial institution using the reserve method of accounting for bad debts, an insurance company, a corporation electing the benefits of the Puerto Rico and possessions tax credit, or a Domestic International Sales Corporation ("DISC") or former DISC.

[31] See, for example, GAO/GGD–00–159, Banking Taxation, Implications of Proposed Revisions Governing S-Corporations on Community Banks (June 23, 2000).

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

EXPLANATION OF PROVISION

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

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

EFFECTIVE DATE

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

2. Expansion of bank S corporation eligible shareholders to include IRAs

PRESENT LAW

An individual retirement account ("IRA") is a trust or account established for the exclusive benefit of an individual and his or her beneficiaries. There are two general types of IRAs: traditional IRAs, to which both deductible and nondeductible contributions may be made, and Roth IRAs, contributions to which are not deductible. Amounts held in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal is a return of nondeductible contributions). Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income; distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings. A qualified distribution is a distribution that (1) is made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) is made after attainment of age 59½, on account of death or disability, or is made for first-time homebuyer expenses of up to $10,000.

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

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

EXPLANATION OF PROVISION

The bill allows an IRA (including a Roth IRA) to be a shareholder of a bank that is an S corporation, but only to the extent

of bank stock held by the IRA on the date of enactment of the provision.[33]

The bill also provides an exemption from prohibited transaction treatment for the sale by an IRA to the IRA beneficiary of bank stock held by the IRA on the date of enactment of the provision. Under the bill, a sale is not a prohibited transaction if: (1) the sale is pursuant to an S corporation election by the bank; (2) the sale is for fair market value (as established by an independent appraiser) and is on terms at least as favorable to the IRA as the terms would be on a sale to an unrelated party; (3) the IRA incurs no commissions, costs, or other expenses in connection with the sale; and (4) the stock is sold in a single transaction for cash not later than 120 days after the S corporation election is made.

EFFECTIVE DATE

The provision takes effect on the date of enactment of the bill.

3. Disregard of unexercised powers of appointment in determining potential current beneficiaries of ESBT

PRESENT LAW

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

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

EXPLANATION OF PROVISION

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

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

EFFECTIVE DATE

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

4. Transfers of suspended losses incident to divorce, etc.

PRESENT LAW

Under present law, any loss or deduction that is not allowed to a shareholder of an S corporation, because the loss exceeds the

[33] Under the bill, the present-law rules treating S corporation stock held by a qualified retirement plan (other than an employee stock ownership plan) or a charity as an interest in an unrelated trade or business apply to an IRA holding S corporation stock of a bank.

shareholder's basis in stock and debt of the corporation, is treated as incurred by the S corporation with respect to that shareholder in the subsequent taxable year.

EXPLANATION OF PROVISION

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

EFFECTIVE DATE

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

5. Use of passive activity loss and at-risk amounts by qualified subchapter S trust income beneficiaries

PRESENT LAW

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

EXPLANATION OF PROVISION

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

EFFECTIVE DATE

The provision applies to transfers made after December 31, 2004.

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

PRESENT LAW

An S corporation is subject to corporate-level tax, at the highest corporate tax rate, on its excess net passive income if the corporation has (1) accumulated earnings and profits at the close of the taxable year and (2) gross receipts more than 25 percent of which are passive investment income.

Excess net passive income is the net passive income for a taxable year multiplied by a fraction, the numerator of which is the amount of passive investment income in excess of 25 percent of gross receipts and the denominator of which is the passive investment income for the year. Net passive income is defined as passive investment income reduced by the allowable deductions that are directly connected with the production of that income. Passive investment income generally means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of

stock or securities (to the extent of gains). Passive investment income generally does not include interest on accounts receivable, gross receipts that are derived directly from the active and regular conduct of a lending or finance business, gross receipts from certain liquidations, or gain or loss from any section 1256 contract (or related property) of an options or commodities dealer.[34]

In addition, an S corporation election is terminated whenever the S corporation has accumulated earnings and profits at the close of each of three consecutive taxable years and has gross receipts for each of those years more than 25 percent of which are passive investment income.

EXPLANATION OF PROVISION

The bill provides that, in the case of a bank (as defined in section 581), a bank holding company (as defined in section 2(a) of the Bank Holding Company Act of 1956), or a financial holding company (as defined in section 2(p) of that Act), interest income and dividends on assets required to be held by the bank or holding company are not treated as passive investment income for purposes of the S corporation passive investment income rules.

EFFECTIVE DATE

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

7. Treatment of bank director shares

PRESENT LAW

An S corporation may have no more than 75 shareholders and may have only one outstanding class of stock.[35]

An S corporation has one class of stock if all outstanding shares of stock confer identical rights to distribution and liquidation proceeds. Differences in voting rights are disregarded.[36]

National banking law requires that a director of a national bank own stock in the bank and that a bank have at least five directors.[37] A number of States have similar requirements for State-chartered banks. Apparently, it is common practice for a bank director to enter into an agreement under which the bank (or a holding company) will reacquire the stock upon the director's ceasing to hold the office of director, at the price paid by the director for the stock.[38]

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[34] Notice 97–5, 1997–1 C.B. 352, sets forth guidance relating to passive investment income on banking assets.

[35] Another provision of the bill increases the maximum number of shareholders to 100.

[36] Sec. 1361(c)(4). Treasury regulations provide that buy-sell and redemption agreements are disregarded in determining whether a corporation's outstanding shares confer identical distribution and liquidation rights unless (1) a principal purpose of the agreement is to circumvent the one class of stock requirement and (2) the agreement establishes a purchase price that, at the time the agreement is entered into, is significantly in excess of, or below, the fair market value of the stock. Treas. Reg. sec. 1.1361–1(l).

[37] 12 U.S.C. secs. 71–72.

[38] See Private Letter Ruling 200217048 (January 24, 2002) describing such an agreement and holding that it creates a second class of stock. Nonetheless, the ruling concluded that the election to be an S corporation was inadvertently invalid and that an amended agreement did not create a second class of stock so that the corporation's election was validated.

EXPLANATION OF PROVISION

Under the bill, restricted bank director stock is not taken into account as outstanding stock in applying the provisions of subchapter S.[39] Thus, the stock is not treated as a second class of stock; a director is not treated as a shareholder of the S corporation by reason of the stock; the stock is disregarded in allocating items of income, loss, etc. among the shareholders; and the stock is not treated as outstanding for purposes of determining whether an S corporation holds 100 percent of the stock of a qualified subchapter S subsidiary.

Restricted bank director stock is stock in a bank (as defined in section 581), a bank holding company (within the meaning of section 2(a) of the Bank Holding Company Act of 1956), or a financial holding company (as defined in section 2(p) of that Act), registered with the Federal Reserve System, if the stock is required to be held by an individual under applicable Federal or State law in order to permit the individual to serve as a director of the bank or holding company and which is subject to an agreement with the bank or holding company (or corporation in control of the bank or company) pursuant to which the holder is required to sell the stock back upon ceasing to be a director at the same price the individual acquired the stock.

A distribution (other than a payment in exchange for the stock) with respect to the restricted stock is includible in the gross income of the director and is deductible by the S corporation for the taxable year that includes the last day of the director's taxable year in which the distribution is included in income.

EFFECTIVE DATE

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

8. Relief from inadvertently invalid qualified subchapter S subsidiary elections and terminations

PRESENT LAW

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

EXPLANATION OF PROVISION

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

EFFECTIVE DATE

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

9. Information returns for qualified subchapter S subsidiaries

PRESENT LAW

Under present law, a corporation all of whose stock is held by an S corporation is treated as a qualified subchapter S subsidiary if

[39] No inference is intended as to the proper tax treatment under present law.

the S corporation so elects. The assets, liabilities, and items of income, deduction, and credit of the subsidiary are treated as assets, liabilities, and items of the parent S corporation.

EXPLANATION OF PROVISION

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

EFFECTIVE DATE

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

10. Repayment of loans for qualifying employer securities

PRESENT LAW

An employee stock ownership plan (an "ESOP") is a defined contribution plan that is designated as an ESOP and is designed to invest primarily in qualifying employer securities. For purposes of ESOP investments, a "qualifying employer security" is defined as: (1) publicly traded common stock of the employer or a member of the same controlled group; (2) if there is no such publicly traded common stock, common stock of the employer (or member of the same controlled group) that has both voting power and dividend rights at least as great as any other class of common stock; or (3) noncallable preferred stock that is convertible into common stock described in (1) or (2) and that meets certain requirements. In some cases, an employer may design a class of preferred stock that meets these requirements and that is held only by the ESOP. Special rules apply to ESOPs that do not apply to other types of qualified retirement plans, including a special exemption from the prohibited transaction rules.

Certain transactions between an employee benefit plan and a disqualified person, including the employer maintaining the plan, are prohibited transactions that result in the imposition of an excise tax.[40] Prohibited transactions include, among other transactions, (1) the sale, exchange or leasing of property between a plan and a disqualified person, (2) the lending of money or other extension of credit between a plan and a disqualified person, and (3) the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of the plan. However, certain transactions are exempt from prohibited transaction treatment, including certain loans to enable an ESOP to purchase qualifying employer securities.[41] In such a case, the employer securities purchased with the loan proceeds are generally pledged as security for the loan. Contributions to the ESOP and dividends paid on employer securities held by the ESOP are used to repay the loan. The employer securities are held in a suspense account and released for allocation to participants' accounts as the loan is repaid.

A loan to an ESOP is exempt from prohibited transaction treatment if the loan is primarily for the benefit of the participants and their beneficiaries, the loan is at a reasonable rate of interest, and

[40] Sec. 4975.

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

the collateral given to a disqualified person consists of only qualifying employer securities. No person entitled to payments under the loan can have the right to any assets of the ESOP other than (1) collateral given for the loan, (2) contributions made to the ESOP to meet its obligations on the loan, and (3) earnings attributable to the collateral and the investment of contributions described in (2).[42] In addition, the payments made on the loan by the ESOP during a plan year cannot exceed the sum of those contributions and earnings during the current and prior years, less loan payments made in prior years.

An ESOP of a C corporation is not treated as violating the qualification requirements of the Code or as engaging in a prohibited transaction merely because, in accordance with plan provisions, a dividend paid with respect to qualifying employer securities held by the ESOP is used to make payments on a loan (including payments of interest as well as principal) that was used to acquire the employer securities (whether or not allocated to participants).[43] In the case of a dividend paid with respect to any employer security that is allocated to a participant, this relief does not apply unless the plan provides that employer securities with a fair market value of not less than the amount of the dividend is allocated to the participant for the year which the dividend would have been allocated to the participant.[44]

EXPLANATION OF PROVISION

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

EFFECTIVE DATE

The provision is effective for distributions made with respect to S corporation stock after December 31, 2004.

[42] Treas. Reg. sec. 54.4975–7(b)(5).
[43] Sec. 404(k)(5)(B).
[44] Sec. 404(k)(2)(B).

## D. Alternative Minimum Tax Relief

### 1. Foreign tax credit under alternative minimum tax; expansion of exemption from alternative minimum tax for small corporations; income averaging for farmers not to increase alternative minimum tax (secs. 241–243 of the bill and secs. 55–59 of the Code)

#### PRESENT LAW

*In general*

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

*Foreign tax credit*

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

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

*Small corporation exemption*

Corporations with average gross receipts of less than $7.5 million for the prior three taxable years are exempt from the corporate AMT. The $7.5 million threshold is reduced to $5 million for the corporation's first 3-taxable year period.

*Farmer income averaging*

An individual taxpayer engaged in a farming business (as defined by section 263A(e)(4)) may elect to compute his or her current year regular tax liability by averaging, over the prior three-year pe-

riod, all or portion of his or her taxable income from the trade or business of farming. Because farmer income averaging reduces the regular tax liability, the AMT may be increased. Thus, the benefits of farmer income averaging may be reduced or eliminated for farmers subject to the AMT.

REASONS FOR CHANGE

The Committee believes that the AMT is merely a prepayment of tax. The corporate AMT requires businesses to prepay their taxes when they can least afford it, during a business downturn. The Committee believes that increasing the gross receipts cap for companies exempt from corporate AMT from $7.5 million of gross receipts to $20 million of gross receipts will relieve many taxpayers of the financial burden of having to prepay their tax when they can least afford it. The provision also will relieve many taxpayers of the administrative cost and compliance burden of having to calculate their taxes under two separate income tax systems. The Committee also believes that taxpayers should be permitted full use of foreign tax credits in computing the AMT. The Committee believes that farmers should be allowed the full benefits of income averaging without incurring liability under the AMT.

EXPLANATION OF PROVISION

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

The provision increases the amount of average gross receipts that an exempt corporation may receive from $7.5 million to $20 million.

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

EFFECTIVE DATE

The provision relating to the foreign tax credit applies to taxable years beginning after December 31, 2004.

The provision relating to the small corporation exemption applies to taxable years beginning after December 31, 2005.

The provision relating to farmers' income averaging applies to taxable years beginning after December 31, 2003.

## E. Restructuring of Incentives for Alcohol Fuels, Etc.

### 1. Reduced rates of tax on alcohol fuel mixtures replaced with an excise tax credit, etc. (secs. 251 and 252 of the bill and secs. 4041, 4081, 4091, 6427 and 9503 of the Code)

PRESENT LAW

*Alcohol fuels income tax credit*

The alcohol fuels credit is the sum of three credits: the alcohol mixture credit, the alcohol credit, and the small ethanol producer

credit. Generally, the alcohol fuels credit expires after December 31, 2007.[45]

A taxpayer (generally a petroleum refiner, distributor, or marketer) who mixes ethanol with gasoline (or a special fuel[46]) is an "ethanol blender." Ethanol blenders are eligible for an income tax credit of 52 cents per gallon of ethanol used in the production of a qualified mixture (the "alcohol mixture credit"). A qualified mixture means a mixture of alcohol and gasoline, (or of alcohol and a special fuel) sold by the blender as fuel, or used as fuel by the blender in producing the mixture. The term alcohol includes methanol and ethanol but does not include (1) alcohol produced from petroleum, natural gas, or coal (including peat), or (2) alcohol with a proof of less than 150. Businesses also may reduce their income taxes by 52 cents for each gallon of ethanol (not mixed with gasoline or other special fuel) that they sell at the retail level as vehicle fuel or use themselves as a fuel in their trade or business ("the alcohol credit"). The 52-cents-per-gallon income tax credit rate is scheduled to decline to 51 cents per gallon during the period 2005 through 2007. For blenders using an alcohol other than ethanol, the rate is 60 cents per gallon.[47]

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

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

*Excise tax reductions for alcohol mixture fuels*

Generally, motor fuels tax rates are as follows:[48]

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

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

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

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

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

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

*Gasohol*

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

The reduced excise tax rates apply to gasohol upon its removal or entry. Gasohol is defined as a gasoline/ethanol blend that contains 5.7 percent ethanol, 7.7 percent ethanol, or 10 percent ethanol. For the calendar year 2004, the following reduced rates apply to gasohol:[49]

| | |
|---|---|
| 5.7 percent ethanol | 15.436 cents per gallon. |
| 7.7 percent ethanol | 14.396 cents per gallon. |
| 10.0 percent ethanol | 13.200 cents per gallon. |

Reduced excise tax rates also apply when gasoline is purchased for the production of "gasohol." When gasoline is purchased for blending into gasohol, the rates above are multiplied by a fraction (e.g., 10/9 for 10-percent gasohol) so that the increased volume of motor fuel will be subject to tax. The reduced tax rates apply if the person liable for the tax is registered with the IRS and (1) produces gasohol with gasoline within 24 hours of removing or entering the gasoline or (2) gasoline is sold upon its removal or entry and such person has an unexpired certificate from the buyer and has no reason to believe the certificate is false.[50]

*Qualified methanol and ethanol fuels*

Qualified methanol or ethanol fuel is any liquid that contains at least 85 percent methanol or ethanol or other alcohol produced from a substance other than petroleum or natural gas. These fuels are taxed at reduced rates.[51] The rate of tax on qualified methanol is 12.35 cents per gallon. The rate on qualified ethanol in 2004 is 13.15 cents. From January 1, 2005 through September 30, 2007, the rate of tax on qualified ethanol is 13.25 cents.

*Alcohol produced from natural gas*

A mixture of methanol, ethanol, or other alcohol produced from natural gas that consists of at least 85 percent alcohol is also taxed at reduced rates.[52] For mixtures not containing ethanol, the applicable rate of tax is 9.25 cents per gallon before October 1, 2005. In all other cases, the rate is 11.4 cents per gallon. After September 30, 2005, the rate is reduced to 2.15 cents per gallon when the mixture does not contain ethanol and 4.3 cents per gallon in all other cases.

*Blends of alcohol and diesel fuel or special motor fuels*

A reduced rate of tax applies to diesel fuel or kerosene that is combined with alcohol as long as at least 10 percent of the finished

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

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

[51] These reduced rates terminate after September 30, 2007. Included in these rates is the 0.05-cent-per-gallon Leaking Underground Storage Tank Trust Fund tax imposed on such fuel. (sec. 4041(b)(2)).

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

mixture is alcohol. If none of the alcohol in the mixture is ethanol, the rate of tax is 18.4 cents per gallon. For alcohol mixtures containing ethanol, the rate of tax in 2004 is 19.2 cents per gallon and 19.3 cents per gallon for 2005 through September 30, 2007. Fuel removed or entered for use in producing a 10 percent diesel-alcohol fuel mixture (without ethanol), is subject to a tax of 20.44 cents per gallon. The rate of tax for fuel removed or entered for use to produce a 10 percent diesel-ethanol fuel mixture is 21.333 cents per gallon for 2004 and 21.444 cents per gallon for the period January 1, 2005 through September 30, 2007.[53]

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

*Aviation fuel*

Noncommercial aviation fuel is subject to a tax of 21.9 cents per gallon.[54] Fuel mixtures containing at least 10 percent alcohol are taxed at lower rates.[55] In the case of 10 percent ethanol mixtures, for any sale or use during 2004, the 21.9 cents is reduced by 13.2 cents (for a tax of 8.7 cents per gallon), for 2005, 2006, and 2007 the reduction is 13.1 cents (for a tax of 8.8 cents per gallon) and is reduced by 13.4 cents in the case of any sale during 2008 or thereafter. For mixtures not containing ethanol, the 21.9 cents is reduced by 14 cents for a tax of 7.9 cents. These reduced rates expire after September 30, 2007.[56]

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

*Refunds and payments*

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

*Ethyl tertiary butyl ether (ETBE)*

Ethyl tertiary butyl ether ("ETBE") is an ether that is manufactured using ethanol. Unlike ethanol, ETBE can be blended with gasoline before the gasoline enters a pipeline because ETBE does not result in contamination of fuel with water while in transport. Treasury regulations provide that gasohol blenders may claim the income tax credit and excise tax rate reductions for ethanol used in the production of ETBE. The regulations also provide a special

[53] These rates include the additional 0.1 cent-per-gallon excise tax to fund the Leaking Underground Storage Tank Trust Fund.

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

[55] Secs. 4041(k)(1) and 4091(c).

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

election allowing refiners to claim the benefit of the excise tax rate reduction even though the fuel being removed from terminals does not contain the requisite percentages of ethanol for claiming the excise tax rate reduction.

*Highway Trust Fund*

With certain exceptions, the taxes imposed by section 4041 (relating to retail taxes on diesel fuels and special motor fuels) and section 4081 (relating to tax on gasoline, diesel fuel and kerosene) are credited to the Highway Trust Fund. In the case of alcohol fuels, 2.5 cents per gallon of the tax imposed is retained in the General Fund.[57] In the case of a taxable fuel taxed at a reduced rate upon removal or entry prior to mixing with alcohol, 2.8 cents of the reduced rate is retained in the General Fund.[58]

*Taxes from gasoline and special motor fuels used in motorboats and gasoline used in the nonbusiness use of small-engine outdoor power equipment*

The Aquatic Resources Trust Fund is funded by a portion of the receipts from the excise tax imposed on motorboat gasoline and special motor fuels, as well as small-engine fuel taxes, that are first deposited into the Highway Trust Fund. As a result, transfers to the Aquatic Resources Trust Fund are governed in part by Highway Trust Fund provisions.[59]

A total tax rate of 18.4 cents per gallon is imposed on gasoline and special motor fuels used in motorboats. Of this rate, 0.1 cent per gallon is dedicated to the Leaking Underground Storage Tank Trust Fund. Of the remaining 18.3 cents per gallon, the Code currently transfers 13.5 cents per gallon from the Highway Trust Fund to the Aquatics Resources Trust Fund and Land and Water Conservation Fund. The remainder, 4.8 cents per gallon, is retained in the General Fund. In addition, the Sport Fish Restoration Account of the Aquatics Resources Trust Fund receives 13.5 cents per gallon of the revenues from the tax imposed on gasoline used as a fuel in the nonbusiness use of small-engine outdoor power equipment. The balance of 4.8 cents per gallon is retained in the General Fund.[60]

REASONS FOR CHANGE

Highway vehicles using alcohol-blended fuels contribute to the wear and tear of the same highway system used by gasoline or diesel vehicles. Therefore, the Committee believes that alcohol-blended fuels should be taxed at rates equal to gasoline or diesel. The Committee believes that present law provides opportunities for fraud because individuals can buy gasoline at reduced tax rates for blending with alcohol, but never actually use the gasoline to make an alcohol fuel blend. The Committee believes that eliminating the reduced tax rate on gasoline prior to blending with alcohol will reduce such opportunities for fraud. The Committee also believes that providing a tax credit based on the gallons of alcohol used to

[57] Sec. 9503(b)(4)(E).
[58] Sec. 9503(b)(4)(F).
[59] Sec. 9503(c)(4) and 9503(c)(5).
[60] The Sport Fish Restoration Account also is funded with receipts from an *ad valorem* manufacturer's excise tax on sport fishing equipment.

make an alcohol fuel and eliminating the various blend tiers associated with reduced tax rates for alcohol-blended fuels will simplify present law.

EXPLANATION OF PROVISION

*Overview*

The provision eliminates reduced rates of excise tax for alcohol-blended fuels and imposes the full rate of excise tax on alcohol-blended fuels (18.4 cents per gallon on gasoline blends and 24.4 cents per gallon of diesel blended fuel). In place of reduced rates, the provision permits the section 40 alcohol mixture credit, with certain modifications, to be applied against excise tax liability. The credit may be taken against the tax imposed on taxable fuels (by section 4081). To the extent a person does not have section 4081 liability, the provision allows taxpayers to file a claim for payment equal to the amount of the credit for the alcohol used to produce an eligible mixture. Under certain circumstances, a tax is imposed if an alcohol fuel mixture credit is claimed with respect to alcohol used in the production of any alcohol mixture, which is subsequently used for a purpose for which the credit is not allowed or changed into a substance that does not qualify for the credit. The provision eliminates the General Fund retention of certain taxes on alcohol fuels, and credits these taxes to the Highway Trust Fund.

*Alcohol fuel mixture excise tax credit and payment provisions*

ALCOHOL FUEL MIXTURE EXCISE TAX CREDIT

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

In lieu of the reduced excise tax rates, the provision provides that the alcohol mixture credit provided under section 40 may be applied against section 4081 excise tax liability (hereinafter referred to as "the alcohol fuel mixture credit"). The credit is treated as a payment of the taxpayer's tax liability received at the time of the taxable event. The alcohol fuel mixture credit is 52 cents for each gallon of alcohol used by a person in producing an alcohol fuel mixture for sale or use in a trade or business of the taxpayer. The credit declines to 51 cents per gallon after calendar year 2004. For mixtures not containing ethanol (renewable source methanol), the credit is 60 cents per gallon. As discussed further below, the excise tax credit is refundable in order to provide a benefit equivalent to the reduced tax rates, which are being repealed under the provision.

For purposes of the alcohol fuel mixture credit, an "alcohol fuel mixture" is a mixture of alcohol and gasoline or alcohol and a special fuel which is sold for use or used as a fuel by the taxpayer producing the mixture. Alcohol for this purpose includes methanol, ethanol, and alcohol gallon equivalents of ETBE or other ethers produced from such alcohol. It does not include alcohol produced from petroleum, natural gas, or coal (including peat), or alcohol with a proof of less than 190 (determined without regard to any added denaturants). Special fuel is any liquid fuel (other than gaso-

line) which is suitable for use in an internal combustion engine. The benefit obtained from the excise tax credit is coordinated with the alcohol fuels income tax credit. For refiners making an alcohol fuel mixture with ETBE, the mixture is treated as sold to another person for use as a fuel only upon removal from the refinery. The excise tax credit is available through December 31, 2010.

*Payments with respect to qualified alcohol fuel mixtures*

To the extent the alcohol fuel mixture credit exceeds any section 4081 liability of a person, the Secretary is to pay such person an amount equal to the alcohol fuel mixture credit with respect to such mixture. These payments are intended to provide an equivalent benefit to replace the partial exemption for fuels to be blended with alcohol and alcohol fuels being repealed by the provision. If claims for payment are not paid within 45 days, the claim is to be paid with interest. The provision also provides that in the case of an electronic claim, if such claim is not paid within 20 days, the claim is to be paid with interest. If claims are filed electronically, the claimant may make a claim for less than $200.

The provision does not apply with respect to alcohol fuel mixtures sold after December 31, 2010.

*Alcohol fuel subsidies borne by General Fund*

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

*Motorboat and small engine fuel taxes*

The provision eliminates the General Fund retention of the 4.8 cents per gallon of the taxes imposed on gasoline and special motor fuels used in motorboats and gasoline used as a fuel in the nonbusiness use of small-engine outdoor power equipment.

EFFECTIVE DATES

The provisions generally are effective for fuel sold or used after September 30, 2004. The repeal of the General Fund retention of the 2.5/2.8 cents per gallon of tax regarding alcohol fuels and the repeal of the 4.8 cents per gallon General Fund retention of the taxes imposed on fuels used in motorboats and small engine equipment is effective for taxes imposed after September 30, 2003. The provision regarding the crediting of the full amount of tax to the Highway Trust Fund without regard to credits and payments is effective for taxes received after September 30, 2004, and payments made after September 30, 2004.

## F. Stock Options and Employee Stock Purchase Plan Stock Options

### 1. Exclusion of incentive stock options and employee stock purchase plan stock options from wages (sec. 261 of the bill and secs. 421(b), 423(c), 3121(a), 3231, and 3306(b) of the Code)

#### PRESENT LAW

Generally, when an employee exercises a compensatory option on employer stock, the difference between the option price and the fair market value of the stock (i.e., the "spread") is includible in income as compensation. In the case of an incentive stock option or an option to purchase stock under an employee stock purchase plan (collectively referred to as "statutory stock options"), the spread is not included in income at the time of exercise.[61]

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

Federal Insurance Contribution Act ("FICA") and Federal Unemployment Tax Act ("FUTA") taxes (collectively referred to as "employment taxes") are generally imposed in an amount equal to a percentage of wages paid by the employer with respect to employment.[62] The applicable Code provisions[63] do not provide an exception from FICA and FUTA taxes for wages paid to an employee arising from the exercise of a statutory stock option.

There has been uncertainty in the past as to employer withholding obligations upon the exercise of statutory stock options. On June 25, 2002, the IRS announced that until further guidance is issued, it would not assess FICA or FUTA taxes, or impose Federal income tax withholding obligations, upon either the exercise of a statutory stock option or the disposition of stock acquired pursuant to the exercise of a statutory stock option.[64]

#### REASONS FOR CHANGE

To provide taxpayers certainty, the Committee believes that it is appropriate to clarify the treatment of statutory stock options for employment tax and income tax withholding purposes. The Committee believes that in the past, the IRS has been inconsistent in its treatment of taxpayers with respect to this issue and did not uniformly challenge taxpayers who did not collect employment taxes and withhold income taxes on statutory stock options.

Until January 2001, the IRS had not published guidance with respect to the imposition of employment taxes and income tax withholding on statutory stock options. Many taxpayers relied on guidance published with respect to qualified stock options (the predecessor to incentive stock options) to take the position that no em-

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

[62] Secs. 3101, 3111 and 3301.

[63] Secs. 3121 and 3306.

[64] Notice 2002–47, 2002–28 I.R.B. 97.

ployment taxes or income tax withholding were required with respect to statutory stock options. It is the Committee's belief that a majority of taxpayers did not withhold employment and income taxes with respect to statutory stock options. Thus, proposed IRS regulations, if implemented, would have altered the treatment of statutory stock options for most employers.

Because there is a specific income tax exclusion with respect to statutory stock options, the Committee believes it is appropriate to clarify that there is a conforming exclusion for employment taxes and income tax withholding. Statutory stock options are required to meet certain Code requirements that do not apply to nonqualified stock options. The Committee believes that such requirements are intended to make statutory stock options a tool of employee ownership rather than a form of compensation subject to employment taxes. Furthermore, this clarification will ensure that, if further IRS guidance is issued, employees will not be faced with a tax increase that will reduce their net paychecks even though their total compensation has not changed.

The clarification will also eliminate the administrative burden and cost to employers who, in the absence of the Committee bill, could be required to modify their payroll systems to provide for the withholding of income and employment taxes on statutory stock options that they are not currently required to withhold.

### EXPLANATION OF PROVISION

The provision provides specific exclusions from FICA and FUTA wages for remuneration on account of the transfer of stock pursuant to the exercise of an incentive stock option or under an employee stock purchase plan, or any disposition of such stock. Thus, under the provision, FICA and FUTA taxes do not apply upon the exercise of a statutory stock option.[65] The provision also provides that such remuneration is not taken into account for purposes of determining Social Security benefits.

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

### EFFECTIVE DATE

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

## G. INCENTIVES TO REINVEST FOREIGN EARNINGS IN THE UNITED STATES

(Sec. 271 of the bill and new sec. 965 of the Code)

### PRESENT LAW

The United States employs a "worldwide" tax system, under which domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Income earned by a domestic parent corporation from foreign operations conducted by

[65] The provision also provides a similar exclusion under the Railroad Retirement Tax Act.

foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income generally is deferred, and U.S. tax is imposed on such income when repatriated. However, under anti-deferral rules, the domestic parent corporation may be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral provisions in this context are the controlled foreign corporation rules of subpart F[66] and the passive foreign investment company rules.[67] A foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income, whether earned directly by the domestic corporation, repatriated as a dividend from a foreign subsidiary, or included in income under the anti-deferral rules.[68]

REASONS FOR CHANGE

The Committee observes that the residual U.S. tax imposed on the repatriation of foreign earnings can serve as a disincentive to repatriate these earnings. The Committee believes that a temporary reduction in the U.S. tax on repatriated dividends will stimulate the U.S. domestic economy by triggering the repatriation of foreign earnings that otherwise would have remained abroad. The Committee emphasizes that this is a temporary economic stimulus measure.

EXPLANATION OF PROVISION

Under the provision, certain dividends received by a U.S. corporation from a controlled foreign corporation are eligible for an 85-percent dividends-received deduction. At the taxpayer's election, this deduction is available for dividends received either: (1) during the first six months of the taxpayer's first taxable year beginning on or after the date of enactment of the bill; or (2) during any six-month or shorter period after the date of enactment of the bill, during the taxpayer's last taxable year beginning before such date. Dividends received after the election period will be taxed in the normal manner under present law.

The deduction applies only to dividends and other amounts included in gross income as dividends (e.g., amounts described in section 1248(a)). The deduction does not apply to items that are not included in gross income as dividends, such as subpart F inclusions or deemed repatriations under section 956. Similarly, the deduction does not apply to distributions of earnings previously taxed under subpart F, except to the extent that the subpart F inclusions result from the payment of a dividend by one controlled foreign corporation to another controlled foreign corporation within a certain chain of ownership during the election period. This exception enables multinational corporate groups to qualify for the deduction in connection with the repatriation of earnings from lower-tier controlled foreign corporations.

[66] Secs. 951–964.
[67] Secs. 1291–1298.
[68] Secs. 901, 902, 960, 1291(g).

The deduction is subject to a number of limitations. First, it applies only to repatriations in excess of the taxpayer's average repatriation level over three of the five most recent taxable years ending on or before March 31, 2003, determined by disregarding the highest-repatriation year and the lowest-repatriation year among such five years (the "base-period average"). In addition to actual dividends, deemed repatriations under section 956 and distributions of earnings previously taxed under subpart F are included in the base-period average.

Second, the amount of dividends eligible for the deduction is limited to the greatest of: (1) $500 million; (2) the amount of earnings shown as permanently invested outside the United States on the taxpayer's most recent audited financial statement which is certified on or before March 31, 2003; or (3) in the case of an applicable financial statement that fails to show a specific amount of such earnings, but that does show a specific amount of tax liability attributable to such earnings, the amount of such earnings determined in such manner as the Treasury Secretary may prescribe.

Third, dividends qualifying for the deduction must be invested in the United States pursuant to a plan approved by the senior management and board of directors of the corporation claiming the deduction.

No foreign tax credit (or deduction) is allowed for foreign taxes attributable to the deductible portion of any dividend received during the taxable year for which an election under the provision is in effect. For this purpose, the taxpayer may specifically identify which dividends are treated as carrying the deduction and which are not; in the absence of such identification, a pro rata amount of foreign tax credits will be disallowed with respect to every dividend received during the taxable year.

In addition, the income attributable to the nondeductible portion of a qualifying dividend may not be offset by net operating losses, and the tax attributable to such income generally may not be offset by credits (other than foreign tax credits and AMT credits) and may not reduce the alternative minimum tax otherwise owed by the taxpayer. No deduction under sections 243 or 245 is allowed for any dividend for which a deduction is allowed under the provision.

#### EFFECTIVE DATE

The provision is effective for a taxpayer's first taxable year beginning on or after the date of enactment of the bill, or the taxpayer's last taxable year beginning before such date, at the taxpayer's election.

## H. OTHER PROVISIONS

### 1. Special rules for livestock sold on account of weather-related conditions (sec. 281 of the bill and secs. 1033 and 451 of the Code)

#### PRESENT LAW

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

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

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

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

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

## REASONS FOR CHANGE

The Committee is aware of situations in which cattlemen sold livestock in excess of their usual business practice as a result of weather-related conditions, but have been unable to purchase replacement property because the weather-related conditions have continued. The Committee believes it is appropriate to extend the time period for cattlemen to purchase replacement property in such situations.

## EXPLANATION OF PROVISION

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

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

EFFECTIVE DATE

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

2. Payment of dividends on stock of cooperatives without reducing patronage dividends (sec. 282 of the bill and sec. 1388 of the Code)

PRESENT LAW

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

Treasury Regulations provide that net earnings are reduced by dividends paid on capital stock or other proprietary capital interests (referred to as the "dividend allocation rule").[69] The dividend allocation rule has been interpreted to require that such dividends be allocated between a cooperative's patronage and nonpatronage operations, with the amount allocated to the patronage operations reducing the net earnings available for the payment of patronage dividends.

REASONS FOR CHANGE

The Committee believes that the dividend allocation rule should not apply to the extent that the organizational documents of a cooperative provide that capital stock dividends do not reduce the amounts owed to patrons as patronage dividends. To the extent that capital stock dividends are in addition to amounts paid under the cooperative's organizational documents to patrons as patronage dividends, the Committee believes that those capital stock dividends are not being paid from earnings from patronage business.

In addition, the Committee believes cooperatives should be able to raise needed equity capital by issuing capital stock without dividends paid on such stock causing the cooperative to be taxed on a portion of its patronage income, and without preventing the cooperative from being treated as operating on a cooperative basis.

[69] Treas. Reg. sec. 1.1388–1(a)(1).

EXPLANATION OF PROVISION

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

EFFECTIVE DATE

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

3. Capital gains treatment to apply to outright sales of timber by landowner (sec. 283 of the bill and sec. 631(b) of the Code)

PRESENT LAW

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

REASONS FOR CHANGE

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

EXPLANATION OF PROVISION

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

EFFECTIVE DATE

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

4. Distributions from publicly traded partnerships treated as qualifying income of regulated investment company (sec. 284 of the bill and secs. 851 and 469(k) of the Code)

PRESENT LAW

*Treatment of RICs*

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

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

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

*Treatment of publicly traded partnerships*

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

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

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

REASONS FOR CHANGE

The Committee understands that publicly traded partnerships generally are treated as corporations under rules enacted to address Congress' view that publicly traded partnerships resemble corporations in important respects.[70] Publicly traded partnerships with specified types of income are not treated as corporations, however, for the reason that if the income is from sources that are commonly considered to be passive investments, then there is less reason to treat the publicly traded partnership as a corporation.[71] The Committee understands that these types of publicly traded partnerships may have improved access to capital markets if their interests were permitted investments of mutual funds. Therefore, the bill treats publicly traded partnership interests as permitted investments for mutual funds ("RICs").

Nevertheless, the Committee believes that permitting mutual funds to hold interests in a publicly traded partnership should not give rise to avoidance of unrelated business income tax or withholding of income tax that would apply if tax-exempt organizations or foreign persons held publicly traded partnership interests directly rather than through a mutual fund. Therefore, the Committee bill requires that present-law limitations on ownership and composition of assets of mutual funds apply to any investment in a publicly traded partnership by a mutual fund. The Committee believes that these limitations will serve to limit the use of mutual funds as conduits for avoidance of unrelated business income tax or withholding rules that would otherwise apply with respect to publicly traded partnership income.

EXPLANATION OF PROVISION

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

[70] H.R. Rep. No. 100–391, pt. 2 of 2, at 1066 (1987).
[71] *Id.*

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

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

EFFECTIVE DATE

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

5. Improvements related to real estate investment trusts (sec. 285 of the bill and secs. 856, 857 and 860 of the Code)

PRESENT LAW

*In general*

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

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

*Organizational structure requirements*

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

*Income requirements*

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

*Qualified rental income*

Amounts received as impermissible "tenant services income" are not treated as rents from real property.[72] In general, such amounts are for services rendered to tenants that are not "customarily furnished" in connection with the rental of real property.[73] Special rules also permit amounts to be received from certain "foreclosure property" treated as such for three years after the property is acquired by the REIT in foreclosure after a default (or imminent default) on a lease of such property or an indebtedness which such property secured.

Rents from real property, for purposes of the 95-percent and 75-percent income tests, generally do not include any amount received or accrued from any person in which the REIT owns, directly or indirectly, 10 percent or more of the vote or value.[74] An exception applies to rents received from a taxable REIT subsidiary ("TRS") (described further below) if at least 90 percent of the leased space of the property is rented to persons other than a TRS or certain related persons, and if the rents from the TRS are substantially comparable to unrelated party rents.[75]

*Certain hedging instruments*

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

*Tax if qualified income tests not met*

If a REIT fails to meet the 95-percent or 75-percent income tests but has set out the income it did receive in a schedule and any error in the schedule is due to reasonable cause and not willful neglect, then the REIT does not lose its REIT status but instead pays a tax measured by the greater of the amount by which 90 percent[76] of the REIT's gross income exceeds the amount of items subject to the 95-percent test, or the amount by which 75 percent of the REIT's gross income exceeds the amount of items subject to the 75-percent test.[77]

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

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

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

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

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

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

*Asset requirements*

*75-percent asset test*

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

*Limitation on investment in other entities*

A REIT is limited in the amount that it can own in other corporations. Specifically, a REIT cannot own securities (other than Government securities and certain real estate assets) in an amount greater than 25 percent of the value of REIT assets. In addition, it cannot own such securities of any one issuer representing more than 5 percent of the total value of REIT assets or more than 10 percent of the voting securities or 10 percent of the value of the outstanding securities of any one issuer. Securities for purposes of these rules are defined by reference to the Investment Company Act of 1940.

*"Straight debt" exception*

Securities of an issuer that are within a safe-harbor definition of "straight debt" (as defined for purposes of subchapter S)[78] are not taken into account in applying the limitation that a REIT may not hold more than 10 percent of the value of outstanding securities of a single issuer, if: (1) the issuer is an individual, (2) the only securities of such issuer held by the REIT or a taxable REIT subsidiary of the REIT are straight debt, or (3) the issuer is a partnership and the trust holds at least a 20 percent profits interest in the partnership.

Straight debt for purposes of the REIT provision[79] is defined as a written or unconditional promise to pay on demand or on a specified date a sum certain in money if (i) the interest rate (and interest payment dates) are not contingent on profits, the borrower's discretion, or similar factors, and (ii) there is no convertibility (directly or indirectly) into stock.

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

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

*Special rules for Taxable REIT subsidiaries*

Under another exception to the general rule limiting REIT securities ownership of other entities, a REIT can own stock of a taxable REIT subsidiary ("TRS"), generally, a corporation other than

[78] Sec. 1361(c)(5), without regard to paragraph (B)(iii) thereof.
[79] Sec. 856(c)(7).

a real estate investment trust[80] with which the REIT makes a joint election to be subject to special rules. A TRS can engage in active business operations that would produce income that would not be qualified income for purposes of the 95-percent or 75-percent income tests for a REIT, and that income is not attributed to the REIT. For example a TRS could provide noncustomary services to REIT tenants, or it could engage directly in the active operation and management of real estate (without use of an independent contractor); and the income the TRS derived from these nonqualified activities would not be treated as disqualified REIT income. Transactions between a TRS and a REIT are subject to a number of specified rules that are intended to prevent the TRS (taxable as a separate corporate entity) from shifting taxable income from its activities to the pass-through entity REIT or from absorbing more than its share of expenses. Under one rule, a 100-percent excise tax is imposed on rents, deductions, or interest paid by the TRS to the REIT to the extent such items would exceed an arm's length amount as determined under section 482.[81]

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

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

*Income distribution requirements*

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

*Consequences of failure to meet requirements*

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

In the case of a failure to meet the source of income requirements, if the failure is due to reasonable cause and not to willful neglect, the REIT may continue its REIT status if it pays the disallowed income as a tax to the Treasury.[82]

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

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

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

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

A REIT may make a deficiency dividend after a determination is made that it has not distributed the correct amount of its income, and avoid disqualification. The Code provides only for determinations involving a controversy with the IRS and does not provide for a REIT to make such a distribution on its own initiative. Deficiency dividends may be declared on or after the date of "determination". A determination is defined to include only (i) a final decision by the Tax Court or other court of competent jurisdiction, (ii) a closing agreement under section 7121, or (iii) under Treasury regulations, an agreement signed by the Secretary and the REIT.

REASONS FOR CHANGE

The Committee believes that a number of simplifying and conforming changes should be made to the "straight debt" provisions that exempt certain securities from the rule that a REIT may not hold more than 10 percent of the value of securities of a single issuer, as well as to the TRS rules, the rules relating to certain hedging arrangements, and the computation of tax liability when the 95-percent gross income test is not met.

The Committee also believes it is desirable to provide rules under which a REIT that inadvertently fails to meet certain REIT qualification requirements can correct such failure without losing REIT status.

EXPLANATION OF PROVISION

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

*Straight debt modification*

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

*Straight debt securities*

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

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

exceeds $1,000,000 and not more than 12 months of unaccrued interest can be required to be prepaid thereunder.

Also, the time or amount of any payment is permitted to be subject to a contingency upon a default or the exercise of a prepayment right by the issuer of the debt, provided that such contingency is consistent with customary commercial practice.[83]

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

Certain corporate or partnership issues that otherwise would be permitted to be held without limitation under the special straight debt rules described above will not be so permitted if the REIT holding such securities, and any of its taxable REIT subsidiaries, holds any securities of the issuer which are not permitted securities (prior to the application of this rule) and have an aggregate value greater than one percent of the issuer's outstanding securities.

*Other securities*

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

*Safe harbor testing date for certain rents*

The provision provides specific safe-harbor rules regarding the dates for testing whether 90 percent of a REIT property is rented to unrelated persons and whether the rents paid by related persons are substantially comparable to unrelated party rents. These testing rules are provided solely for purposes of the special provision permitting rents received from a TRS to be treated as qualified rental income for purposes of the income tests.[84]

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

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

*Customary services exception*

The provision prospectively eliminates the safe harbor allowing rents received by a REIT to be exempt from the 100 percent excise tax if the rents are for customary services performed by the TRS[85] or are from a TRS and are for the provision of certain incidental personal property. Instead, such payments are free of the excise tax if they satisfy the present law safe-harbor that applies if the REIT pays the TRS at least 150 percent of the cost to the TRS of providing any services.

*Hedging rules*

The rules governing the tax treatment of arrangements engaged in by a REIT to reduce certain interest rate risks are prospectively generally conformed to the rules included in section 1221. Also, the defined income of a REIT from such a hedging transaction is excluded from gross income for purposes of the 95-percent of gross income requirement.

*95-percent of gross income requirement*

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

*Consequences of failure to meet REIT requirements*

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

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

One requirement of present law is that, with certain exceptions, (i) not more than 5 percent of the value of total REIT assets may be represented by securities of one issuer, and (ii) a REIT may not hold securities possessing more than 10 percent of the total voting power or 10 percent of the total value of the outstanding securities of any one issuer.[86] The requirements must be satisfied each quarter.

The provision provides that a REIT will not lose its REIT status for failing to satisfy these requirements in a quarter if the failure is due to the ownership of assets the total value of which does not exceed the lesser of (i) one percent of the total value of the REIT's assets at the end of the quarter for which such measurement is done or (ii) 10 million dollars; provided in either case that the REIT either disposes of the assets within six months after the last day of the quarter in which the REIT identifies the failure (or such

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

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

other time period prescribed by the Treasury), or otherwise meets the requirements of those rules by the end of such time period.[87]

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

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

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

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

*Conforming reasonable cause and reporting standard for failures of income tests*

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

*Other failures*

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

*Taxes and penalties paid deducted from amount required to be distributed*

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

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

*Expansion of deficiency dividend procedure*

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

EFFECTIVE DATE

The provision is generally effective for taxable years beginning after December 31, 2000.

However, some of the provisions are effective for taxable years beginning after the date of enactment. These are: the new "look through" rules determining a REIT partner's share of partnership securities for purposes of the "straight debt" rules; the provision changing the 90-percent of gross income reference to 95 percent, for purposes of the tax liability if a REIT fails to meet the 95-percent of gross income test; the new hedging definition; the rule modifying the treatment of rents with respect to customary services; and the new rules for correction of certain failures to satisfy the REIT requirements.

6. Treatment of certain dividends of regulated investment companies (sec. 286 of the bill and secs. 871 and 881 of the Code)

PRESENT LAW

*Regulated investment companies*

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

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

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

A RIC generally may pass through to its shareholders the character of its long-term capital gains. It does this by designating a dividend it pays as a capital gain dividend to the extent that the

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

*U.S. source investment income of foreign persons*

*In general*

The United States generally imposes a flat 30-percent tax, collected by withholding, on the gross amount of U.S.-source investment income payments, such as interest, dividends, rents, royalties or similar types of income, to nonresident alien individuals and foreign corporations ("foreign persons") (secs. 871(a), 881, 1441, and 1442). Under treaties, the United States may reduce or eliminate such taxes. Even taking into account U.S. treaties, however, the tax on a dividend generally is not entirely eliminated. Instead, U.S.-source portfolio investment dividends received by foreign persons generally are subject to U.S. withholding tax at a rate of at least 15 percent.

*Interest*

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

*Capital gains*

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

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

*Estate taxation*

Decedents who were citizens or residents of the United States are generally subject to Federal estate tax on all property, wherever situated.[88] Nonresidents who are not U.S. citizens, however, are subject to estate tax only on their property which is within the United States. Property within the United States generally includes debt obligations of U.S. persons, including the Federal government and State and local governments (sec. 2104(c)), but does not include either bank deposits or portfolio obligations, the interest on which would be exempt from U.S. income tax under section 871 (sec. 2105(b)). Stock owned and held by a nonresident who is not a U.S. citizen is treated as property within the United States only if the stock was issued by a domestic corporation (sec. 2104(a); Treas. Reg. sec. 20.2104–1(a)(5)).

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

REASONS FOR CHANGE

Under present law, a disparity exists between foreign persons who invest directly in certain interest-bearing and other securities

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

and a foreign person who invests in such securities indirectly through U.S. mutual funds. In general, certain amounts received by the direct foreign investor (or a foreign investor through a foreign fund) may be exempt from the U.S. gross-basis withholding tax. In contrast, distributions from a RIC generally are treated as dividends subject to the withholding tax, notwithstanding that the distributions may be attributable to amounts that otherwise could qualify for an exemption from withholding tax. U.S. financial institutions often respond to this disparate treatment by forming "mirror funds" outside the United States. The Committee believes that such disparate treatment should be eliminated so that U.S. financial institutions will be encouraged to form and operate their mutual funds within the United States rather than outside the United States.

Therefore, the Committee believes that, to the extent a RIC distributes to a foreign person a dividend attributable to amounts that would have been exempt from U.S. withholding tax had the foreign person received it directly (such as portfolio interest and capital gains, including short-term capital gains), such dividend similarly should be exempt from the U.S. gross-basis withholding tax. The Committee also believes that comparable treatment should be afforded for estate tax purposes to foreign persons who invest in certain assets through a RIC to the extent that such assets would not be subject to the estate tax if held directly.

EXPLANATION OF PROVISION

*In general*

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

*Interest-related dividends*

Under the bill, a RIC may, under certain circumstances, designate all or a portion of a dividend as an "interest-related dividend," by written notice mailed to its shareholders not later than 60 days after the close of its taxable year. In addition, an interest-related dividend received by a foreign person generally is exempt

from U.S. gross-basis tax under sections 871(a), 881, 1441 and 1442.

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

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

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

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

If the amount designated as an interest-related dividend is greater than the qualified net interest income described above, the por-

tion of the distribution so designated which constitutes an interest-related dividend will be only that proportion of the amount so designated as the amount of the qualified net interest income bears to the amount so designated.

*Short-term capital gain dividends*

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

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

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

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

*Estate tax treatment*

Under the bill, a portion of the stock in a RIC held by the estate of a nonresident decedent who is not a U.S. citizen is treated as property without the United States. The portion so treated is based

upon the proportion of the assets held by the RIC at the end of the quarter immediately preceding the decedent's death (or such other time as the Secretary may designate in regulations) that are "qualifying assets". Qualifying assets for this purpose are bank deposits of the type that are exempt from gross-basis income tax, portfolio debt obligations, certain original issue discount obligations, debt obligations of a domestic corporation that are treated as giving rise to foreign source income, and other property not within the United States.

EFFECTIVE DATE

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

7. Taxation of certain settlement funds (sec. 287 of the bill and sec. 468B of the Code)

PRESENT LAW

In general, section 468B provides that a payment to a designated settlement fund that extinguishes a tort liability of the taxpayer will result in a deduction to the taxpayer. A designated settlement fund means a fund which is established pursuant to a court order, extinguishes the taxpayer's tort liability, is managed and controlled by persons unrelated to the taxpayer, and in which the taxpayer does not have a beneficial interest in the trust.

Generally, a designated or qualified settlement fund is taxed as a separate entity at the maximum trust rate on its modified income. Modified income is generally gross income less deductions for administrative costs and other incidental expenses incurred in connection with the operation of the settlement fund.

The cleanup of hazardous waste sites is sometimes funded by environmental "settlement funds" or escrow accounts. These escrow accounts are established in consent decrees between the Environmental Protection Agency ("EPA") and the settling parties under the jurisdiction of a Federal district court. The EPA uses these accounts to resolve claims against private parties under Comprehensive Environmental Response, Compensation and Liability Act of 1980 ("CERCLA").

Present law provides that nothing in any provision of law is to be construed as providing that an escrow account, settlement fund, or similar fund is not subject to current income tax.

REASONS FOR CHANGE

The Committee believes that these environmental escrow accounts, established under court consent decrees, are essential for the EPA to resolve or satisfy claims under the Comprehensive Environmental Response, Compensation and Liability Act of 1980. The tax treatment of these settlement funds may prevent taxpayers from entering into prompt settlements with the EPA for the cleanup of Superfund hazardous waste sites and reduce the ulti-

mate amount of funds available for the sites' cleanup. As these settlement funds are controlled by the government, the Committee believes it is appropriate to establish that these funds are to be treated as beneficially owned by the United States.

EXPLANATION OF PROVISION

The provision provides that certain settlement funds established in consent decrees for the sole purpose of resolving claims under CERCLA are to be treated as beneficially owned by the United States government and therefore, not subject to Federal income tax.

To qualify the settlement fund must be: (1) established pursuant to a consent decree entered by a judge of a United States District Court; (2) created for the receipt of settlement payments for the sole purpose of resolving claims under CERCLA; (3) controlled (in terms of expenditures of contributions and earnings thereon) by the government or an agency or instrumentality thereof; and (4) upon termination, any remaining funds will be disbursed to such government entity and used in accordance with applicable law. For purposes of the provision, a government entity means the United States, any State of political subdivision thereof, the District of Columbia, any possession of the United States, and any agency or instrumentality of the foregoing.

EFFECTIVE DATE

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

8. Expand human clinical trials expenses qualifying for the orphan drug tax credit (sec. 288 of the bill and sec. 45C of the Code)

PRESENT LAW

Taxpayers may claim a 50-percent credit for expenses related to human clinical testing of drugs for the treatment of certain rare diseases and conditions, generally those that afflict less than 200,000 persons in the United States. Qualifying expenses are those paid or incurred by the taxpayer after the date on which the drug is designated as a potential treatment for a rare disease or disorder by the Food and Drug Administration ("FDA") in accordance with section 526 of the Federal Food, Drug, and Cosmetic Act.

REASONS FOR CHANGE

The Committee observes that approval for human clinical testing, and designation as a potential treatment for a rare disease or disorder, require separate reviews within the FDA. As a result, in some cases, a taxpayer may be permitted to begin human clinical testing prior to a drug being designated as a potential treatment for a rare disease or disorder. If the taxpayer delays human clinical testing in order to obtain the benefits of the orphan drug tax credit, which currently may be claimed only for expenses incurred after the drug is designated as a potential treatment for a rare disease or disorder, valuable testing and research time will have been lost and Congress's original intent in enacting the orphan drug tax credit will have been partially thwarted.

By submitting an application with the FDA for designation as a treatment of certain rare diseases and conditions, the taxpayer is indicating that he or she intends to examine the drug as a potential treatment for a qualifying disease or condition in approved clinical trials. The FDA is required to approve drugs for human clinical testing before testing can commence. The Committee believes the application for designation as a potential treatment for a rare disease or disorder can create a starting point from which human clinical testing expenses can be measured for purposes of the credit. For those cases where the process of filing an application and receiving designation as a potential treatment for a rare disease or disorder occurs sufficiently expeditiously to fall entirely within the taxpayer's taxable year plus permitted return filing extension period, the Committee finds it appropriate to eliminate the potential financial incentive to delaying clinical testing by permitting testing expenses paid or incurred prior to designation to qualify for the credit. The Committee recognizes that while such an outcome may well describe most applications, in some cases, particularly for applications filed near the close of a taxpayer's taxable year, in other cases the application and designation of the drug will not be made within the requisite period. The Committee chooses not to expand qualifying expenses to include those expenses paid or incurred after the date on which the taxpayer files an application with FDA for designation of the drug as a potential treatment for a rare disease or disorder, in the case when the designation is approved with respect to a taxable year subsequent to the year in which the application is filed, because to do so may create the additional taxpayer burden of requiring the taxpayer to file an amended return to claim credit for qualifying costs related to expenses incurred in a taxable year prior to designation.

### EXPLANATION OF PROVISION

The provision expands qualifying expenses to include those expenses related to human clinical testing paid or incurred after the date on which the taxpayer files an application with the FDA for designation of the drug under section 526 of the Federal Food, Drug, and Cosmetic Act as a potential treatment for a rare disease or disorder, if certain conditions are met. Under the provision, qualifying expenses include those expenses paid or incurred after the date on which the taxpayer files an application with the FDA for designation as a potential treatment for a rare disease or disorder if the drug receives FDA designation before the due date (including extensions) for filing the tax return for the taxable year in which the application was filed with the FDA. As under present law, the credit may only be claimed for such expenses related to drugs designated as a potential treatment for a rare disease or disorder by the FDA in accordance with section 526 of such Act.

### EFFECTIVE DATE

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

## 9. Simplification of excise tax imposed on bows and arrows (sec. 289 of the bill and sec. 4161 of the Code)

### PRESENT LAW

The Code imposes an excise tax of 11 percent on the sale by a manufacturer, producer or importer of any bow with a draw weight of 10 pounds or more.[89] An excise tax of 12.4 percent is imposed on the sale by a manufacturer or importer of any shaft, point, nock, or vane designed for use as part of an arrow which after its assembly (1) is over 18 inches long, or (2) is designed for use with a taxable bow (if shorter than 18 inches).[90] No tax is imposed on finished arrows. An 11-percent excise tax also is imposed on any part of an accessory for taxable bows and on quivers for use with arrows (1) over 18 inches long or (2) designed for use with a taxable bow (if shorter than 18 inches).[91]

### REASONS FOR CHANGE

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

### EXPLANATION OF PROVISION

The provision increases the draw weight for a taxable bow from 10 pounds or more to a peak draw weight of 30 pounds or more.[92] The provision also imposes an excise tax of 12 percent on arrows generally. An arrow for this purpose is defined as a taxable arrow shaft to which additional components are attached. The present law 12.4-percent excise tax on certain arrow components is unchanged by the bill. In the case of any arrow comprised of a shaft or any other component upon which tax has been imposed, the amount of the arrow tax is equal to the excess of (1) the arrow tax that would have been imposed but for this exception, over (2) the amount of tax paid with respect to such components.[93] Finally, the provision subjects certain broadheads (a type of arrow point) to an excise tax equal to 11 percent of the sales price instead of 12.4 percent.

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

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

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

[92] Draw weight is the maximum force required to bring the bowstring to a full-draw position not less than 26¼-inches, measured from the pressure point of the hand grip to the nocking position on the bowstring.

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

EFFECTIVE DATE

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

10. Repeal excise tax on fishing tackle boxes (sec. 290 of the bill and sec. 4162 of the Code)

PRESENT LAW

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

REASONS FOR CHANGE

The Committee observes that fishing "tackle boxes" are little different in design and appearance from "tool boxes," yet the former are subject to a Federal excise tax at a rate of 10-percent, while the latter are not subject to Federal excise tax. This excise tax can create a sufficiently large price difference that some fishermen will choose to use a "tool box" to hold their hooks and lures rather than a traditional "tackle box." The Committee finds that such a distortion of consumer choice places an inappropriate burden on the manufacturers and purchasers of traditional tackle boxes, particularly in comparison to the modest amount of revenue raised by the present-law provision, and that this burden warrants repeal of the tax. The excise tax also adds unwarranted complexity to the Code, by requiring taxpayers and the IRS to make highly factual determinations as to which similar-use items are subject to tax and which are not.[94]

EXPLANATION OF PROVISION

The provision repeals the excise tax on fishing tackle boxes.

EFFECTIVE DATE

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

11. Repeal of excise tax on sonar devices suitable for finding fish (sec. 291 of the bill and secs. 4161 and 4162 of the Code)

PRESENT LAW

In general, the Code imposes a 10 percent tax on the sale by the manufacturer, producer, or importer of specified sport fishing

[94] The Joint Committee on Taxation has cited the tackle box issue as an example of the complexity of the sport fishing excise tax, and has recommended the elimination of the sport fishing equipment excise tax. See Joint Committee on Taxation, Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986, (JCS–3–01), Vol. II, Recommendations of the Staff of the Joint Committee on Taxation to Simplify the Federal Tax System, at 499–500, April 2001.

equipment.[95] A three percent rate, however, applies to the sale of electric outboard motors and sonar devices suitable for finding fish.[96] Further, the tax imposed on the sale of sonar devices suitable for finding fish is limited to $30. A sonar device suitable for finding fish does not include any device that is a graph recorder, a digital type, a meter readout, a combination graph recorder or combination meter readout.[97]

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

REASONS FOR CHANGE

The Committee observes that the current exemption for certain forms of sonar devices has the effect of exempting almost all of the devices currently on the market. The Committee understands that only one form of sonar device is not exempt from the tax, those units utilizing light-emitting diode ("LED") display technology. The Committee understands that LED devices are currently not exempt from the tax because the technology was developed after the exemption for the other technologies was enacted. In the Committee's view, the application of the tax to LED display devices, and not to devices performing the same function with a different technology, creates an unfair advantage for the exempt devices. Because most of the devices on the market already are exempt, the Committee believes it is appropriate to level the playing field by repealing the tax imposed on all sonar devices suitable for finding fish. The Committee believes this is a more suitable solution than exempting a device from the tax based on the type of technology used.

EXPLANATION OF PROVISION

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

EFFECTIVE DATE

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

12. Income tax credit for cost of carrying tax-paid distilled spirits in wholesale inventories (sec. 292 of the bill and new sec. 5011 of the Code)

PRESENT LAW

As is true of most major Federal excise taxes, the excise tax on distilled spirits is imposed at a point in the chain of distribution before the product reaches the retail (consumer) level. Tax on domestically produced and/or bottled distilled spirits arises upon production (receipt) in a bonded distillery and is collected based on removals from the distillery during each semi-monthly period. Distilled spirits that are bottled before importation into the United

[95] Sec. 4161(a)(1).
[96] Sec. 4161(a)(2).
[97] Sec. 4162(b).

States are taxed on removal from the first U.S. warehouse where they are landed (including a warehouse located in a foreign trade zone).

No tax credits are allowed under present law for business costs associated with having tax-paid products in inventory. Rather, excise tax that is included in the purchase price of a product is treated the same as the other components of the product cost, i.e., deductible as a cost of goods sold.

### REASONS FOR CHANGE

Under current law, wholesale importers of distilled spirits are not required to pay the Federal excise tax on imported spirits until after the product is removed from a bonded warehouse for sale to a retailer. In contrast, the tax on domestically produced spirits is included as part of the purchase price and passed on from the supplier to wholesaler. It is the Committee's understanding that in some instances, wholesalers can carry this tax-paid inventory for an average of 60 days before selling it to a retailer. To provide equivalent tax treatment of domestic and imported product, the Committee believes it is appropriate to provide an income tax credit to approximate the interest charge—more commonly referred to as float—that results from carrying tax-paid distilled spirits in inventory.

### EXPLANATION OF PROVISION

The provision creates a new income tax credit for eligible wholesale distributors of distilled spirits. An eligible wholesaler is any person who holds a permit under the Federal Alcohol Administration Act as a wholesaler of distilled spirits.

The credit is calculated by multiplying the number of cases of bottled distilled spirits by the average tax-financing cost per case for the most recent calendar year ending before the beginning of such taxable year. A case is 12 80-proof 750-milliliter bottles. The average tax-financing cost per case is the amount of interest that would accrue at corporate overpayment rates during an assumed 60-day holding period on an assumed tax rate of $22.83 per case of 12 750-milliliter bottles.

The credit only applies to domestically bottled distilled spirits[98] purchased directly from the bottler of such spirits. The credit is in addition to present-law rules allowing tax included in inventory costs to be deducted as a cost of goods sold.

The credit cannot be carried back to a taxable year beginning before January 1, 2005.

### EFFECTIVE DATE

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

[98] Distilled spirits that are imported in bulk and then bottled domestically qualify as domestically bottled distilled spirits.

## 13. Suspension of occupational taxes relating to distilled spirits, wine, and beer (sec. 293 of the bill and new sec. 5148 of the Code)

### PRESENT LAW

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

| | |
|---|---|
| Producers:[99] | |
| Distilled spirits and wines (sec. 5081) | $1,000 per year, per premise. |
| Brewers (sec. 5091) | $1,000 per year, per premise. |
| Wholesale dealers (sec. 5111): | |
| Liquors, wines, or beer | $500 per year. |
| Retail dealers (sec. 5121): | |
| Liquors, wines, or beer | $250 per year. |
| Nonbeverage use of distilled spirits (sec. 5131) | $500 per year. |
| Industrial use of distilled spirits (sec. 5276) | $250 per year. |

The Code requires every wholesale or retail dealer in liquors, wine or beer to keep records of their transactions.[100] A delegate of the Secretary of the Treasury is authorized to inspect the records of any dealer during business hours.[101] There are penalties for failing to comply with the recordkeeping requirements.[102]

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

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

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

(3) a person who is not required to pay special occupational tax as a wholesale dealer in liquors.[103]

In addition, a limited retail dealer (such as a charitable organization selling liquor at a picnic) may lawfully purchase distilled spirits for resale from a retail dealer in liquors.[104]

Violation of this restriction is punishable by $1,000 fine, imprisonment of one year, or both.[105] A violation also makes the alcohol subject to seizure and forfeiture.[106]

### REASONS FOR CHANGE

The special occupational tax is not a tax on alcoholic products but rather operates as a license fee on businesses. The Committee believes that this tax places an unfair burden on business owners. However, the Committee recognizes that the recordkeeping and

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

[100] Secs. 5114, 5124.

[101] Sec. 5146.

[102] Sec. 5603.

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

registration authorities applicable to wholesalers and retailers engaged in such businesses are necessary enforcement tools to ensure the protection of the revenue arising from the excise taxes on these products. Thus, the Committee believes it appropriate to suspend the tax for a three-year period, while retaining present-law recordkeeping and registration requirements.

EXPLANATION OF PROVISION

Under the provision, the special occupational taxes on producers and marketers of alcoholic beverages are suspended for a three-year period, July 1, 2004 through June 30, 2007. Present law recordkeeping and registration requirements will continue to apply, notwithstanding the suspension of the special occupation taxes. In addition, during the suspension period, it shall be unlawful for any dealer to purchase distilled spirits for resale from any person other than a wholesale dealer in liquors who is subject to the recordkeeping requirements, except that a limited retail dealer may purchase distilled spirits for resale from a retail dealer in liquors, as permitted under present law.

EFFECTIVE DATE

The provision is effective on the date of enactment.

14. Exclusion of certain indebtedness of small business investment companies from acquisition indebtedness (sec. 294 of the bill and sec. 514 of the Code)

PRESENT LAW

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

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

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

REASONS FOR CHANGE

Small business investment companies obtain financial assistance from the Small Business Administration in the form of equity or by incurring indebtedness that is held or guaranteed by the Small Business Administration pursuant to the Small Business Investment Act of 1958. Tax-exempt organizations that invest in small business investment companies who are treated as partnerships and who incur indebtedness that is held or guaranteed by the Small Business Administration may be subject to unrelated business income tax on their distributive shares of income from the small business investment company. The Committee believes that the imposition of unrelated business income tax in such cases creates a disincentive for tax-exempt organizations to invest in small business investment companies, thereby reducing the amount of investment capital that may be provided by small business investment companies to the nation's small businesses. The Committee believes, however, that ownership limitations on the percentage interests that may be held by exempt organizations are appropriate to prevent all or most of a small business investment company's income from escaping Federal income tax.

EXPLANATION OF PROVISION

The provision modifies the debt-financed property provisions by excluding from the definition of acquisition indebtedness any indebtedness incurred by a small business investment company licensed under the Small Business Investment Act of 1958 that is evidenced by a debenture (1) issued by such company under section 303(a) of said Act, and (2) held or guaranteed by the Small Business Administration. The exclusion shall not apply during any period that any exempt organization (other than a governmental unit) owns more than 25 percent of the capital or profits interest in the small business investment company, or exempt organizations (including governmental units other than any agency or instrumentality of the United States) own, in the aggregate, 50 percent or more of the capital or profits interest in such company.

EFFECTIVE DATE

The provision is effective for small business investment companies formed after the date of enactment.

15. Election to determine taxable income from certain international shipping activities using per ton rate (sec. 295 of the bill and new secs. 1352–1359 of the Code)

PRESENT LAW

The United States employs a "worldwide" tax system, under which domestic corporations generally are taxed on all income, including income from shipping operations, whether derived in the

United States or abroad. In order to mitigate double taxation, a foreign tax credit for income taxes paid to foreign countries is provided to reduce or eliminate the U.S. tax owed on such income, subject to certain limitations.

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

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

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

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

## REASONS FOR CHANGE

In general, operators of U.S.-flag vessels in international trade are subject to higher taxes than their foreign-based competition. The uncompetitive U.S. taxation of shipping income has caused a steady and substantial decline of the U.S. shipping industry. The Committee believes that this provision will provide operators of U.S.-flag vessels in international trade the opportunity to be competitive with their tax-advantaged foreign competitors.

## EXPLANATION OF PROVISION

### *In general*

The provision generally allows corporations to elect a "tonnage tax" on their taxable income from certain shipping activities in lieu of the U.S. corporate income tax. Accordingly, a corporation's income from qualifying shipping activities is no longer taxable under sections 11, 55, 882, 887 or 1201(a) under the regime, and electing entities are only subject to tax at the maximum corporate income tax rate on a notional amount based on the net tonnage of a corporation's qualifying vessels. However, a foreign corporation is not

subject to tax under the tonnage tax regime to the extent its income from qualifying shipping activities is subject to an exclusion for certain shipping operations by foreign corporations pursuant to section 883(a)(1) or pursuant to a treaty obligation of the United States.

*Taxable income from qualifying shipping activities*

Generally, the taxable income of an electing corporation from qualifying shipping activities is the corporate income percentage[107] of the sum of the taxable income from each of its qualifying vessels. The taxable income from each qualifying vessel is the product of (1) the daily notional taxable income[108] from the operation of the qualifying vessel in United States foreign trade,[109] and (2) the number of days during the taxable year that the electing entity operated such vessel as a qualifying vessel in U.S. foreign trade.[110] A "qualifying vessel" is described as a self-propelled U.S.-flag vessel of not less than 10,000 deadweight tons used in U.S. foreign trade.

An entity's qualifying shipping activities consist of its (1) core qualifying activities, (2) qualifying secondary activities, and (3) qualifying incidental activities. Generally, core qualifying activities are activities from operating vessels in U.S. foreign trade and other activities of an electing entity and an electing group that are an integral part of the business of operating qualifying vessels in U.S. foreign trade. Qualifying secondary activities generally consist of the active management or operation of vessels in U.S. foreign trade and provisions for vessel, container and cargo-related facilities or such other activities as may be prescribed by the Secretary (which are not core activities), and may not exceed 20 percent of the aggregate gross income derived from electing entities and other members of its electing group from their core qualifying activities. Qualifying incidental activities are activities that are incidental to core qualifying activities and are not qualifying secondary activities. The aggregate gross income from qualifying incidental activities cannot exceed one-tenth of one percent of the aggregate gross income from the core qualifying activities of the electing entities and other members of its electing group.

*Items not subject to corporate income tax*

Generally, gross income from an electing entity does not include the corporate income percentage of an entity's (1) income from

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[107] The "corporate income percentage" is the least aggregate share, expressed as a percentage, of any item of income or gain of an electing corporation, or an electing group (i.e., a controlled group of which one or more members is an electing entity) of which such corporation is a member from qualifying shipping activities that would otherwise be required to be reported on the U.S. Federal income tax return of an electing corporation during any taxable period. A "controlled group" is any group of trusts and business entities whose members would be treated as a single employer under the rules of section 52(a) (without regard to paragraphs (1) and (2) and section 52(b)(1)).

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

[109] "U.S. foreign trade" means the transportation of goods or passengers between a place in the United States and a foreign place or between foreign places. As a general rule, the temporary operation in the U.S. domestic trade (i.e., the transportation of goods or passengers between places in the United States) of any qualifying vessel is disregarded. However, a vessel that is no longer used for operations in U.S. foreign trade (unless such non-use is on a temporary basis) ceases to be a qualifying vessel when such non-use begins.

[110] If there are multiple operators of a vessel, the taxable income of such vessel must be allocated among such persons on the basis of their ownership and charter interests or another basis that Treasury may prescribe in regulations.

qualifying shipping activities in U.S. foreign trade, (2) income from money, bank deposits and other temporary investments which are reasonably necessary to meet the working capital requirements of its qualifying shipping activities, and (3) income from money or other intangible assets accumulated pursuant to a plan to purchase qualifying shipping assets.[111] Generally, the corporate loss percentage[112] of each item of loss, deduction, or credit is disallowed with respect to any activity the income from which is excluded from gross income under the provision. The corporate loss percentage of an electing entity's interest expense is disallowed in the ratio that the fair market value of its qualifying shipping assets bears to the fair market value of its total assets.

*Allocation of credits, income and deductions*

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

*Qualifying shipping assets*

If an electing entity sells or disposes of qualifying shipping assets in an otherwise taxable transaction, at the election of the entity no gain is recognized if replacement qualifying shipping assets are acquired during a limited replacement period except to the extent that the amount realized upon such sale or disposition exceeds the cost of the replacement qualifying shipping assets. In the case of replacement qualifying shipping assets purchased by an electing entity which results in the nonrecognition of any part of the gain realized as the result of a sale or other disposition of qualifying shipping assets, the basis is the cost of such replacement property decreased in the amount of gain not recognized. If the property purchased consists of more than one piece of property, the basis is allocated to the purchased properties in proportion to their respective costs.

The election not to recognize gain on the disposition and replacement of qualifying shipping assets is not available if the replacement qualifying shipping assets are acquired from a related person except to the extent that the related person (as defined under section 267(b) or 707(b)(1)) acquired the replacement qualifying ship-

[111] "Qualifying shipping assets" means any qualifying vessel and other assets which are used in core qualifying activities.

[112] "Corporate loss percentage" means the greatest aggregate share, expressed as a percentage, of any item of loss, deduction or credit of an electing corporation or electing group of which such corporation is a member from qualifying shipping activities that would otherwise be required to be reported on the U.S. Federal income tax return of an electing corporation during any taxable period.

ping assets from an unrelated person during a limited replacement period.

*Election*

Generally, any qualifying entity may elect into the tonnage tax regime by filing an election with the qualifying entity's income tax return for the first taxable year to which the election applies. However, a qualifying entity, which is a member of a controlled group, may only make an election into the tonnage tax regime if all qualifying entities that are members of the controlled group make such an election. Once made, an election is effective for the taxable year in which it was made and for all succeeding taxable years of the entity until the election is terminated. An election may be terminated if the entity ceases to be a qualifying entity or if the election is revoked. In the event that a qualifying entity elects into the tonnage tax regime and subsequently revokes the election, such entity is barred from electing back into the regime until the fifth taxable year after the termination is effective, unless the Secretary of the Treasury consents to the election.

A qualifying entity means a trust or business entity that (1) operates one or more qualifying vessels and (2) meets the "shipping activity requirement."[113] The shipping activity requirement is met for a taxable year only by an entity that meets one of the following requirements: (1) in the first taxable year of its election into the tonnage tax regime, for the preceding taxable year on average at least 25 percent of the aggregate tonnage of the qualifying vessels which were operated by the entity were owned by the entity or bareboat chartered to the entity; (2) in the second or any subsequent taxable year of its election into the tonnage tax regime, in each of the two preceding taxable years on average at least 25 percent of the aggregate tonnage of the qualifying vessels which were operated by the entity were owned by the entity or bareboat chartered to the entity; or (3) requirements (1) or (2) above would be met if the 25 percent average tonnage requirement was applied on an aggregate basis to the controlled group of which such entity is a member, and vessel charters between members of the controlled group were disregarded.

EFFECTIVE DATE

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

[113] An entity is generally treated as operating any vessel owned by or chartered to the entity. However, an entity is treated as operating a vessel that it has chartered out on bareboat basis only if: (1) the vessel is temporarily surplus to the entity's requirements and the term of the charter does not exceed three years or (2) the vessel is bareboat chartered to a member of a controlled group which includes such entity or to an unrelated third party that sub-bareboats or time charters the vessel to a member of such controlled group (including the owner). Special rules apply in an instance in which an electing entity temporarily ceases to operate a qualifying vessel.

## 16. Charitable contribution deduction for certain expenses in support of native Alaskan subsistence whaling (sec. 296 of the bill and sec. 170 of the Code)

### PRESENT LAW

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

No charitable contribution deduction is allowed for a contribution of services. However, unreimbursed expenditures made incident to the rendition of services to an organization, contributions to which are deductible, may constitute a deductible contribution.[114] Specifically, section 170(j) provides that no charitable contribution deduction is allowed for traveling expenses (including amounts expended for meals and lodging) while away from home, whether paid directly or by reimbursement, unless there is no significant element of personal pleasure, recreation, or vacation in such travel.

### REASONS FOR CHANGE

The Committee believes that subsistence bowhead whale hunting activities are important to certain native peoples of Alaska and further charitable purposes. The Committee believes that certain expenses paid by individuals recognized as whaling captains by the Alaska Eskimo Whaling Commission in the conduct of sanctioned whaling activities conducted pursuant to the management plan of that Commission should be deductible expenses.

### EXPLANATION OF PROVISION

The provision allows individuals to claim a deduction under section 170 not exceeding $10,000 per taxable year for certain expenses incurred in carrying out sanctioned whaling activities. The deduction is available only to an individual who is recognized by the Alaska Eskimo Whaling Commission as a whaling captain charged with the responsibility of maintaining and carrying out sanctioned whaling activities. The deduction is available for reasonable and necessary expenses paid by the taxpayer during the taxable year for: (1) the acquisition and maintenance of whaling boats, weapons, and gear used in sanctioned whaling activities; (2) the supplying of food for the crew and other provisions for carrying out such activities; and (3) the storage and distribution of the catch from such activities. The Committee intends that the Secretary shall require that the taxpayer substantiate deductible expenses by maintaining appropriate written records that show, for example, the time, place, date, amount, and nature of the expense, as well as the taxpayer's eligibility for the deduction, and that such substantiation be provided as part of the taxpayer's income tax return, to the extent provided by the Secretary.

For purposes of the provision, the term "sanctioned whaling activities" means subsistence bowhead whale hunting activities con-

[114] Treas. Reg. sec. 1.170A–1(g).

ducted pursuant to the management plan of the Alaska Eskimo Whaling Commission.

EFFECTIVE DATE

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

## TITLE III—TAX REFORM AND SIMPLIFICATION FOR UNITED STATES BUSINESSES

### A. INTEREST EXPENSE ALLOCATION RULES

(Sec. 301 of the bill and sec. 864 of the Code)

PRESENT LAW

*In general*

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

In the case of interest expense, the rules generally are based on the approach that money is fungible and that interest expense is properly attributable to all business activities and property of a taxpayer, regardless of any specific purpose for incurring an obligation on which interest is paid.[115] For interest allocation purposes, the Code provides that all members of an affiliated group of corporations generally are treated as a single corporation (the so-called "one-taxpayer rule") and allocation must be made on the basis of assets rather than gross income.

*Affiliated group*

*In general*

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

*Definition of affiliated group—consolidated return rules*

For consolidation purposes, the term "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation, but only if: (1) the common parent owns directly stock possessing at least 80 percent of the total voting power and

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

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

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

*Definition of affiliated group—special interest allocation rules*

Subject to exceptions, the consolidated return and interest allocation definitions of affiliation generally are consistent with each other.[116] For example, both definitions generally exclude all foreign corporations from the affiliated group. Thus, while debt generally is considered fungible among the assets of a group of domestic affiliated corporations, the same rules do not apply as between the domestic and foreign members of a group with the same degree of common control as the domestic affiliated group.

*Banks, savings institutions, and other financial affiliates*

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

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

REASONS FOR CHANGE

The Committee observes that the United States is the only country that currently imposes harsh and anti-competitive interest expense allocation rules on its businesses and workers. The present-law interest expense allocation rules result in U.S. companies allocating a portion of their U.S. interest expense against foreign-

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

source income, even when the foreign operation has its own debt. The tax effect of this rule is that U.S. companies end up paying double tax. The practical effect is that the cost for U.S. companies to borrow in the United States is increased and it becomes more expensive to invest in the United States. The Committee believes that these rules should be modified so that U.S. companies are not discouraged from investing in the United States. To this end, U.S. companies should not be required to allocate U.S. interest expense against foreign-source income (and thereby incur double taxation) unless their debt-to-asset ratio is higher in the United States than in foreign countries.

EXPLANATION OF PROVISION

*In general*

The provision modifies the present-law interest expense allocation rules (which generally apply for purposes of computing the foreign tax credit limitation) by providing a one-time election under which the taxable income of the domestic members of an affiliated group from sources outside the United States generally is determined by allocating and apportioning interest expense of the domestic members of a worldwide affiliated group on a worldwide-group basis (i.e., as if all members of the worldwide group were a single corporation). If a group makes this election, the taxable income of the domestic members of a worldwide affiliated group from sources outside the United States is determined by allocating and apportioning the third-party interest expense of those domestic members to foreign-source income in an amount equal to the excess (if any) of (1) the worldwide affiliated group's worldwide third-party interest expense multiplied by the ratio which the foreign assets of the worldwide affiliated group bears to the total assets of the worldwide affiliated group,[117] over (2) the third-party interest expense incurred by foreign members of the group to the extent such interest would be allocated to foreign sources if the provision's principles were applied separately to the foreign members of the group.[118]

For purposes of the new elective rules based on worldwide fungibility, the worldwide affiliated group means all corporations in an affiliated group (as that term is defined under present law for interest allocation purposes)[119] as well as all controlled foreign corporations that, in the aggregate, either directly or indirectly,[120] would be members of such an affiliated group if section 1504(b)(3)

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

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

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

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

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

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

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

*Financial institution group election*

The provision allows taxpayers to apply the present-law bank group rules to exclude certain financial institutions from the affiliated group for interest allocation purposes under the worldwide fungibility approach. The provision also provides a one-time "financial institution group" election that expands the present-law bank group. Under the provision, at the election of the common parent of the pre-election worldwide affiliated group, the interest expense allocation rules are applied separately to a subgroup of the worldwide affiliated group that consists of (1) all corporations that are part of the present-law bank group, and (2) all "financial corporations." For this purpose, a corporation is a financial corporation if at least 80 percent of its gross income is financial services income (as described in section 904(d)(2)(C)(i) and the regulations thereunder) that is derived from transactions with unrelated persons.[121] For these purposes, items of income or gain from a transaction or series of transactions are disregarded if a principal purpose for the transaction or transactions is to qualify any corporation as a financial corporation.

The common parent of the pre-election worldwide affiliated group must make the election for the first taxable year beginning after December 31, 2008, in which a worldwide affiliated group includes a financial corporation. Once made, the election applies to the financial institution group for the taxable year and all subsequent taxable years. In addition, the provision provides anti-abuse rules

[121] See Treas. Reg. sec. 1.904–4(e)(2).

under which certain transfers from one member of a financial institution group to a member of the worldwide affiliated group outside of the financial institution group are treated as reducing the amount of indebtedness of the separate financial institution group. The provision provides regulatory authority with respect to the election to provide for the direct allocation of interest expense in circumstances in which such allocation is appropriate to carry out the purposes of the provision, prevent assets or interest expense from being taken into account more than once, or address changes in members of any group (through acquisitions or otherwise) treated as affiliated under this provision.

EFFECTIVE DATE

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

## B. Recharacterization of Overall Domestic Loss

(Sec. 302 of the bill and sec. 904 of the Code)

PRESENT LAW

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

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

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

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

the recapture is to reduce the foreign tax credit limitation in one or more years following an OFL year and, therefore, the amount of U.S. tax that can be offset by foreign tax credits in the later year or years.

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

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

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

### REASONS FOR CHANGE

The Committee believes that it is important to create parity in the treatment of overall foreign losses and overall domestic losses in order to prevent the double taxation of income. The Committee believes that preventing double taxation will make U.S. businesses more competitive and will lead to increased export sales. The Committee believes that this increase in export sales will increase pro-

duction in the United States and increase jobs in the United States to support the increased exports.

EXPLANATION OF PROVISION

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

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

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

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

EFFECTIVE DATE

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

## C. Reduction to Two Foreign Tax Credit Baskets

(Sec. 303 of the bill and sec. 904 of the Code)

PRESENT LAW

*In general*

The United States taxes its citizens and residents on their worldwide income. Because the countries in which income is earned also may assert their jurisdiction to tax the same income on the basis of source, foreign-source income earned by U.S. persons may be

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

The foreign tax credit limitation is applied separately to the following categories of income: (1) passive income, (2) high withholding tax interest, (3) financial services income, (4) shipping income, (5) certain dividends received from noncontrolled section 902 foreign corporations ("10/50 companies"),[122] (6) certain dividends from a domestic international sales corporation or former domestic international sales corporation, (7) taxable income attributable to certain foreign trade income, (8) certain distributions from a foreign sales corporation or former foreign sales corporation, and (9) any other income not described in items (1) through (8) (so-called "general basket" income). In addition, a number of other provisions of the Code and U.S. tax treaties effectively create additional separate limitations in certain circumstances.[123]

*Financial services income*

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

Treasury regulations provide that a person is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business for any year if for that year at least 80 percent of its gross income is "active financing income."[124] The regulations further provide that a corporation that is not predominantly engaged in the active conduct of a banking, insurance, financing, or similar business under the preceding definition can derive financial services income if the corporation is a member of an affiliated group (as defined in section 1504(a), but expanded to include foreign corporations) that, as a whole, meets the regulatory test of

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

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

[124] Treas. Reg. sec. 1.904–4(e)(3)(i) and (2)(i).

being "predominantly engaged."[125] In determining whether an affiliated group is "predominantly engaged," only the income of members of the group that are U.S. corporations, or controlled foreign corporations in which such U.S. corporations own (directly or indirectly) at least 80 percent of the total voting power and value of the stock, are counted.

*"Base difference" items*

Under Treasury regulations, foreign taxes are allocated and apportioned to the same limitation categories as the income to which they relate.[126] In cases in which foreign law imposes tax on an item of income that does not constitute income under U.S. tax principles (a "base difference" item), the tax is treated as imposed on income in the general limitation category.[127]

REASONS FOR CHANGE

The Committee believes that requiring taxpayers to separate income and tax credits into nine separate tax baskets creates some of the most complex tax reporting and compliance issues in the Code. Reducing the number of foreign tax credit baskets to two will greatly simplify the Code and undo much of the complexity created by the Tax Reform Act of 1986. The Committee believes that simplifying these rules will reduce double taxation, make U.S. businesses more competitive, and create jobs in the United States.

EXPLANATION OF PROVISION

*In general*

The provision generally reduces the number of foreign tax credit limitation categories to two: passive category income and general category income. Other income is included in one of the two categories, as appropriate. For example, shipping income generally falls into the general limitation category, whereas high withholding tax interest generally could fall into the passive income or the general limitation category, depending on the circumstances. Dividends from a domestic international sales corporation or former domestic international sales corporation, income attributable to certain foreign trade income, and certain distributions from a foreign sales corporation or former foreign sales corporation all are assigned to the passive income limitation category. The provision does not affect the separate computation of foreign tax credit limitations under special provisions of the Code relating to, for example, treaty-based sourcing rules or specified countries under section 901(j).

*Financial services income*

In the case of a member of a financial services group or any other person predominantly engaged in the active conduct of a banking, insurance, financing or similar business, the provision treats income meeting the definition of financial services income as general category income. Under the provision, a financial services group is an affiliated group that is predominantly engaged in the

[125] Treas. Reg. sec. 1.904–4(e)(3)(ii).
[126] Treas. Reg. sec. 1.904–6.
[127] Treas. Reg. sec. 1.904–6(a)(1)(iv).

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

The provision does not alter the present law interpretation of what it means to be a "person predominantly engaged in the active conduct of a banking, insurance, financing, or similar business."[128] Thus, other provisions of the Code that rely on this same concept of a "person predominantly engaged in the active conduct of a banking, insurance, financing, or similar business" are not affected by the provision. For example, under the "accumulated deficit rule" of section 952(c)(1)(B), subpart F income inclusions of a U.S. shareholder attributable to a "qualified activity" of a controlled foreign corporation may be reduced by the amount of the U.S. shareholder's pro rata share of certain prior year deficits attributable to the same qualified activity. In the case of a qualified financial institution, qualified activity consists of any activity giving rise to foreign personal holding company income, but only if the controlled foreign corporation was predominantly engaged in the active conduct of a banking, financing, or similar business in both the year in which the corporation earned the income and the year in which the corporation incurred the deficit. Similarly, in the case of a qualified insurance company, qualified activity consists of activity giving rise to insurance income or foreign personal holding company income, but only if the controlled foreign corporation was predominantly engaged in the active conduct of an insurance business in both the year in which the corporation earned the income and the year in which the corporation incurred the deficit. For this purpose, "predominantly engaged in the active conduct of a banking, insurance, financing, or similar business" is defined under present law by reference to the use of the term for purposes of the separate foreign tax credit limitations.[129] The present-law meaning of "predominantly engaged" for purposes of section 952(c)(1)(B) remains unchanged under the provision.

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

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[128] See Treas. Reg. sec. 1.904–4(e).

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

*"Base difference" items*

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

EFFECTIVE DATE

The provision is effective for taxable years beginning after December 31, 2006.

Taxes paid or accrued in a taxable year beginning before January 1, 2007, and carried to any subsequent taxable year are treated as if this provision were in effect on the date such taxes were paid or accrued. Thus, such taxes are assigned to one of the two foreign tax credit limitation categories, as appropriate.

The Treasury Secretary is given authority to provide by regulations for the allocation of income with respect to taxes carried back to pre-effective-date years (in which more than two limitation categories are in effect).

## D. Look-Through Rules To Apply to Dividends From Noncontrolled Section 902 Corporations

(Sec. 304 of the bill and sec. 904 of the Code)

PRESENT LAW

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

Special foreign tax credit limitations apply in the case of dividends received from a foreign corporation in which the taxpayer owns at least 10 percent of the stock by vote and which is not a controlled foreign corporation (a so-called "10/50 company"). Dividends paid by a 10/50 company that is not a passive foreign investment company out of earnings and profits accumulated in taxable years beginning before January 1, 2003 are subject to a single foreign tax credit limitation for all 10/50 companies (other than passive foreign investment companies).[130] Dividends paid by a 10/50 company that is a passive foreign investment company out of earnings and profits accumulated in taxable years beginning before January 1, 2003, continue to be subject to a separate foreign tax credit limitation for each such 10/50 company. Dividends paid by a 10/50 company out of earnings and profits accumulated in taxable years after December 31, 2002 are treated as income in a foreign tax credit limitation category in proportion to the ratio of the 10/50 company's earnings and profits attributable to income in such foreign tax credit limitation category to its total earnings and profits (a "look-through" approach).

For these purposes, distributions are treated as made from the most recently accumulated earnings and profits. Regulatory authority is granted to provide rules regarding the treatment of dis-

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

tributions out of earnings and profits for periods prior to the taxpayer's acquisition of such stock.

REASONS FOR CHANGE

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

EXPLANATION OF PROVISION

The provision generally applies the look-through approach to dividends paid by a 10/50 company regardless of the year in which the earnings and profits out of which the dividend is paid were accumulated.[131] If the Treasury Secretary determines that a taxpayer has inadequately substantiated that it assigned a dividend from a 10/50 company to the proper foreign tax credit limitation category, the dividend is treated as passive category income for foreign tax credit basketing purposes.[132]

EFFECTIVE DATE

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

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

## E. Attribution of Stock Ownership Through Partnerships To Apply in Determining Section 902 and 960 Credits

(Sec. 305 of the bill and secs. 901, 902, and 960 of the Code)

PRESENT LAW

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

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

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

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

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

The foreign tax credit provisions in the Code do not specifically address whether a domestic corporation owning ten percent or more of the voting stock of a foreign corporation through a partnership is entitled to a deemed-paid foreign tax credit.[133] In Rev. Rul. 71–141,[134] the IRS held that a foreign corporation's stock held indirectly by two domestic corporations through their interests in a domestic general partnership is attributed to such domestic corporations for purposes of determining the domestic corporations' eligibility to claim a deemed-paid foreign tax credit with respect to the foreign taxes paid by such foreign corporation. Accordingly, a general partner of a domestic general partnership is permitted to claim deemed-paid foreign tax credits with respect to a dividend distribution from the foreign corporation to the partnership.

However, in 1997, the Treasury Department issued final regulations under section 902, and the preamble to the regulations states that "[t]he final regulations do not resolve under what circumstances a domestic corporate partner may compute an amount of foreign taxes deemed paid with respect to dividends received from a foreign corporation by a partnership or other pass-through entity."[135] In recognition of the holding in Rev. Rul. 71–141, the preamble to the final regulations under section 902 states that a "domestic shareholder" for purposes of section 902 is a domestic corporation that "owns" the requisite voting stock in a foreign cor-

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

[134] 1971–1 C.B. 211.

[135] T.D. 8708, 1997–1 C.B. 137.

poration rather than one that "owns directly" the voting stock. At the same time, the preamble states that the IRS is still considering under what other circumstances Rev. Rul. 71–141 should apply. Consequently, uncertainty remains regarding whether a domestic corporation owning ten percent or more of the voting stock of a foreign corporation through a partnership is entitled to a deemed-paid foreign tax credit (other than through a domestic general partnership).

REASONS FOR CHANGE

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

EXPLANATION OF PROVISION

The provision clarifies that a domestic corporation is entitled to claim deemed-paid foreign tax credits with respect to a foreign corporation that is held indirectly through a foreign or domestic partnership, provided that the domestic corporation owns (indirectly through the partnership) ten percent or more of the foreign corporation's voting stock. No inference is intended as to the treatment of such deemed-paid foreign tax credits under present law. The provision also clarifies that both individual and corporate partners (or estate or trust beneficiaries) may claim direct foreign tax credits with respect to their proportionate shares of taxes paid or accrued by a partnership (or estate or trust).

EFFECTIVE DATE

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

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

(Sec. 306 of the bill and sec. 367 of the Code)

PRESENT LAW

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

The Taxpayer Relief Act of 1997 (the "1997 Act") repealed a rule that treated all such deemed payments as giving rise to U.S.-source income. Because the foreign tax credit is generally limited to the U.S. tax imposed on foreign-source income, the prior-law rule reduced the taxpayer's ability to claim foreign tax credits. As a result

of the repeal of the rule, the source of payments deemed received under section 367(d) is determined under general sourcing rules. These rules treat income from sales of intangible property for contingent payments the same as royalties, with the result that the deemed payments may give rise to foreign-source income.[136]

The 1997 Act did not address the characterization of the deemed payments for purposes of applying the foreign tax credit separate limitation categories.[137] If the deemed payments are treated like proceeds of a sale, then they could fall into the passive category; if the deemed payments are treated like royalties, then in many cases they could fall into the general category (under look-through rules applicable to payments of dividends, interest, rents, and royalties received from controlled foreign corporations).[138]

REASONS FOR CHANGE

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

EXPLANATION OF PROVISION

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

EFFECTIVE DATE

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

## G. United States Property Not To Include Certain Assets of Controlled Foreign Corporation

(Sec. 307 of the bill and sec. 956 of the Code)

PRESENT LAW

In general, the subpart F rules[139] require U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation ("U.S. 10-percent shareholders") to include in taxable income their pro rata shares of certain income of the controlled foreign corporation (referred to as "subpart F income") when such income is earned, whether or not the earnings are distributed currently to the shareholders. In addition, the U.S. 10-percent shareholders of a controlled foreign corporation are subject to U.S. tax on their pro rata shares of the controlled foreign corporation's earnings to the extent invested by the controlled foreign corporation in certain U.S. property in a taxable year.[140]

A shareholder's income inclusion with respect to a controlled foreign corporation's investment in U.S. property for a taxable year is

[136] Secs. 865(d), 862(a).
[137] Sec. 904(d).
[138] Sec. 904(d)(3).
[139] Secs. 951–964.
[140] Sec. 951(a)(1)(B).

based on the controlled foreign corporation's average investment in U.S. property for such year. For this purpose, the U.S. property held (directly or indirectly) by the controlled foreign corporation must be measured as of the close of each quarter in the taxable year.[141] The amount taken into account with respect to any property is the property's adjusted basis as determined for purposes of reporting the controlled foreign corporation's earnings and profits, reduced by any liability to which the property is subject. The amount determined for inclusion in each taxable year is the shareholder's pro rata share of an amount equal to the lesser of: (1) the controlled foreign corporation's average investment in U.S. property as of the end of each quarter of such taxable year, to the extent that such investment exceeds the foreign corporation's earnings and profits that were previously taxed on that basis; or (2) the controlled foreign corporation's current or accumulated earnings and profits (but not including a deficit), reduced by distributions during the year and by earnings that have been taxed previously as earnings invested in U.S. property.[142] An income inclusion is required only to the extent that the amount so calculated exceeds the amount of the controlled foreign corporation's earnings that have been previously taxed as subpart F income.[143]

For purposes of section 956, U.S. property generally is defined to include tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person, and certain intangible assets including a patent or copyright, an invention, model or design, a secret formula or process or similar property right which is acquired or developed by the controlled foreign corporation for use in the United States.[144]

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

[141] Sec. 956(a).
[142] Secs. 956 and 959.
[143] Secs. 951(a)(1)(B) and 959.
[144] Sec. 956(c)(1).

ordinary course of its business as a securities or commodities dealer.[145]

REASONS FOR CHANGE

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

EXPLANATION OF PROVISION

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

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

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

EFFECTIVE DATE

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

## H. Election Not To Use Average Exchange Rate for Foreign Tax Paid Other Than in Functional Currency

(Sec. 308 of the bill and sec. 986 of the Code)

PRESENT LAW

For taxpayers that take foreign income taxes into account when accrued, present law provides that the amount of the foreign tax credit generally is determined by translating the amount of foreign taxes paid in foreign currencies into a U.S. dollar amount at the average exchange rate for the taxable year to which such taxes re-

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

late.[146] This rule applies to foreign taxes paid directly by U.S. taxpayers, which taxes are creditable in the year paid or accrued, and to foreign taxes paid by foreign corporations that are deemed paid by a U.S. corporation that is a shareholder of the foreign corporation, and hence creditable in the year that the U.S. corporation receives a dividend or has an income inclusion from the foreign corporation. This rule does not apply to any foreign income tax: (1) that is paid after the date that is two years after the close of the taxable year to which such taxes relate; (2) of an accrual-basis taxpayer that is actually paid in a taxable year prior to the year to which the tax relates; or (3) that is denominated in an inflationary currency (as defined by regulations).

Foreign taxes that are not eligible for translation at the average exchange rate generally are translated into U.S. dollar amounts using the exchange rates as of the time such taxes are paid. However, the Secretary is authorized to issue regulations that would allow foreign tax payments to be translated into U.S. dollar amounts using an average exchange rate for a specified period.[147]

### REASONS FOR CHANGE

The Committee believes that taxpayers generally should be permitted to elect whether to translate foreign income tax payments using an average exchange rate for the taxable year or the exchange rate when the taxes are paid, provided the elected method continues to be applied consistently unless revoked with the consent of the Treasury Secretary.

### EXPLANATION OF PROVISION

For taxpayers that are required under present law to translate foreign income tax payments at the average exchange rate, the provision provides an election to translate such taxes into U.S. dollar amounts using the exchange rates as of the time such taxes are paid, provided the foreign income taxes are denominated in a currency other than the taxpayer's functional currency.[148] Any election under the provision applies to the taxable year for which the election is made and to all subsequent taxable years unless revoked with the consent of the Secretary. The provision authorizes the Secretary to issue regulations that apply the election to foreign income taxes attributable to a qualified business unit.

### EFFECTIVE DATE

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

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

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

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

## I. Repeal of Withholding Tax on Dividends From Certain Foreign Corporations

(Sec. 309 of the bill and sec. 871 of the Code)

### PRESENT LAW

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

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

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

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

If a foreign corporation is subject to the branch profits tax, then no secondary withholding tax is imposed on dividends paid by the foreign corporation to its shareholders (sec. 884(e)(3)(A)). If a for-

eign corporation is a qualified resident of a tax treaty country and claims an exemption from the branch profits tax pursuant to the treaty, the secondary withholding tax could apply with respect to dividends it pays to its shareholders. Several tax treaties (including treaties that prevent imposition of the branch profits tax), however, exempt dividends paid by the foreign corporation from the secondary withholding tax.

REASONS FOR CHANGE

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

EXPLANATION OF PROVISION

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

EFFECTIVE DATE

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

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

(Sec. 310 of the bill and sec. 861 of the Code)

PRESENT LAW

In general, interest income from bonds, notes or other interest-bearing obligations of noncorporate U.S. residents or domestic corporations is treated as U.S.-source income.[149] Other interest (e.g., interest on obligations of foreign corporations and foreign partnerships) generally is treated as foreign-source income. However, Treasury regulations provide that a foreign partnership is a U.S. resident for purposes of this rule if at any time during its taxable year it is engaged in a trade or business in the United States.[150] Therefore, any interest received from such a foreign partnership is U.S.-source income.

Notwithstanding the general rule described above, in the case of a foreign corporation engaged in a U.S. trade or business (or having gross income that is treated as effectively connected with the conduct of a U.S. trade or business), interest paid by such U.S. trade or business is treated as if it were paid by a domestic corporation (i.e., such interest is treated as U.S.-source income).[151]

REASONS FOR CHANGE

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

[149] Sec. 861(a)(1).
[150] Treas. Reg. sec. 1.861–2(a)(2).
[151] Sec. 884(f)(1).

States should be sourced in the same manner as interest payments from a foreign corporation engaged in a trade or business in the United States.

EXPLANATION OF PROVISION

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

EFFECTIVE DATE

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

## K. Look-Through Treatment of Payments Between Related Controlled Foreign Corporations Under Foreign Personal Holding Company Income Rules

(Sec. 311 of the bill and sec. 954 of the Code)

PRESENT LAW

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

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

REASONS FOR CHANGE

Most countries allow their companies to redeploy active foreign earnings with no additional tax burden. The Committee believes that this provision will make U.S. companies and U.S. workers more competitive with respect to such countries. By allowing U.S. companies to reinvest their active foreign earnings where they are most needed without incurring the immediate additional tax that companies based in many other countries never incur, the Com-

mittee believes that the provision will enable U.S. companies to make more sales overseas, and thus produce more goods in the United States.

EXPLANATION OF PROVISION

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

EFFECTIVE DATE

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

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

(Sec. 312 of the bill and sec. 954 of the Code)

PRESENT LAW

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

REASONS FOR CHANGE

The Committee believes that the sale of a partnership interest by a controlled foreign corporation that owns a significant interest in the partnership should constitute subpart F income only to the ex-

tent that a proportionate sale of the underlying partnership assets attributable to the partnership interest would constitute subpart F income.

EXPLANATION OF PROVISION

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

EFFECTIVE DATE

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

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

(Sec. 313 of the bill and secs. 542, 551–558, 954, 1246, and 1247 of the Code)

PRESENT LAW

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

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

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

ings tax rules (secs. 531–537); and the foreign investment company rules (secs. 1246–1247).

REASONS FOR CHANGE

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

EXPLANATION OF PROVISION

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

EFFECTIVE DATE

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

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

(Sec. 314 of the bill and sec. 954 of the Code)

PRESENT LAW

*Subpart F foreign personal holding company income*

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

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

With respect to transactions in commodities, foreign personal holding company income does not consist of gains or losses which arise out of bona fide hedging transactions that are reasonably nec-

essary to the conduct of any business by a producer, processor, merchant, or handler of a commodity in the manner in which such business is customarily and usually conducted by others.[152] In addition, foreign personal holding company income does not consist of gains or losses which are comprised of active business gains or losses from the sale of commodities, but only if substantially all of the controlled foreign corporation's business is as an active producer, processor, merchant, or handler of commodities.[153]

*Hedging transactions*

Under present law, the term "capital asset" does not include any hedging transaction which is clearly identified as such before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe).[154] The term "hedging transaction" means any transaction entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily: (1) to manage risk of price changes or currency fluctuations with respect to ordinary property which is held or to be held by the taxpayer; (2) to manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer; or (3) to manage such other risks as the Secretary may prescribe in regulations.[155]

REASONS FOR CHANGE

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

EXPLANATION OF PROVISION

The provision modifies the requirements that must be satisfied for gains or losses from a commodities hedging transaction to qualify for exclusion from the definition of subpart F foreign personal holding company income. Under the provision, gains or losses from a transaction with respect to a commodity are not treated as for-

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

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

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

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

eign personal holding company income if the transaction satisfies the general definition of a hedging transaction under section 1221(b)(2). For purposes of this provision, the general definition of a hedging transaction under section 1221(b)(2) is modified to include any transaction with respect to a commodity entered into by a controlled foreign corporation in the normal course of the controlled foreign corporation's trade or business primarily: (1) to manage risk of price changes or currency fluctuations with respect to ordinary property or property described in section 1231(b) which is held or to be held by the controlled foreign corporation; or (2) to manage such other risks as the Secretary may prescribe in regulations. Gains or losses from a transaction that satisfies the modified definition of a hedging transaction are excluded from the definition of foreign personal holding company income only if the transaction is clearly identified as a hedging transaction in accordance with the hedge identification requirements that apply generally to hedging transactions under section 1221(b)(2).[156]

The provision also changes the requirements that must be satisfied for active business gains or losses from the sale of commodities to qualify for exclusion from the definition of foreign personal holding company income. Under the provision, such gains or losses are not treated as foreign personal holding company income if substantially all of the controlled foreign corporation's commodities are comprised of: (1) stock in trade of the controlled foreign corporation or other property of a kind which would properly be included in the inventory of the controlled foreign corporation if on hand at the close of the taxable year, or property held by the controlled foreign corporation primarily for sale to customers in the ordinary course of the controlled foreign corporation's trade or business; (2) property that is used in the trade or business of the controlled foreign corporation and is of a character which is subject to the allowance for depreciation under section 167; or (3) supplies of a type regularly used or consumed by the controlled foreign corporation in the ordinary course of a trade or business of the controlled foreign corporation.[157]

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

EFFECTIVE DATE

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

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

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

## O. Modifications to Treatment of Aircraft Leasing and Shipping Income

(Sec. 315 of the bill and sec. 954 of the Code)

### PRESENT LAW

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

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

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

Subpart F foreign personal holding company income does not include rents and royalties received by a CFC in the active conduct of a trade or business from unrelated persons (sec. 954(c)(2)(A)). The determination of whether rents or royalties are derived in the active conduct of a trade or business is based on all the facts and circumstances. However, the Treasury regulations provide certain types of rents are treated as derived in the active conduct of a trade or business. These include rents derived from property that is leased as a result of the performance of marketing functions by the lessor if the lessor (through its own officers or employees located in a foreign country) maintains and operates an organization in such country that regularly engages in the business of marketing, or marketing and servicing, the leased property and that is substantial in relation to the amount of rents derived from the leasing of such property. An organization in a foreign country is substantial in relation to rents if the active leasing expenses[158] equal at least 25 percent of the adjusted leasing profit.[159]

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

REASONS FOR CHANGE

In general, other countries do not tax foreign shipping income, whereas the United States imposes immediate U.S. tax on such income. The uncompetitive U.S. taxation of shipping income has directly caused a steady and substantial decline of the U.S. shipping industry. The Committee believes that this provision will provide U.S. shippers the opportunity to be competitive with their tax-advantaged foreign competitors.

In addition, the Committee believes that the current-law exception from foreign base company income for rents and royalties received by a CFC in the active conduct of a trade or business from unrelated persons is too narrow in the context of the leasing of an aircraft or vessel in foreign commerce. The Committee believes the provision of the safe harbor under the bill will improve the competitiveness of U.S.-based multinationals engaging in these activities.

EXPLANATION OF PROVISION

The provision repeals the subpart F rules relating to foreign base company shipping income. The bill also amends the exception from foreign personal holding company income applicable to rents or royalties derived from unrelated persons in an active trade or business, by providing a safe harbor for rents derived from leasing an

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

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

aircraft or vessel in foreign commerce. Such rents are excluded from foreign personal holding company income if the active leasing expenses comprise at least 10 percent of the profit on the lease. This provision is to be applied in accordance with existing regulations under sec. 954(c)(2)(A) by comparing the lessor's "active leasing expenses" for its pool of leased assets to its "adjusted leasing profit."

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

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

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

The Committee anticipates that taxpayers now eligible for the benefits of the ETI exclusion (or the FSC provisions pursuant to the FSC Repeal and Extraterritorial Income Exclusion Act of 2000), will find it appropriate, as a matter of sound business judgment, to restructure their business operations to take into account the tax law changes brought about by the bill. The Committee notes that courts have recognized the validity of structuring operations for the purpose of obtaining the benefit of tax regimes expressly intended by Congress. The Committee intends that structuring or restructuring of operations for the purposes of adapting to the repeal of the ETI exclusion (or the FSC regime) will be considered to serve a valid business purpose and will not constitute tax avoidance, where the restructured operations conform to the requirements expressly mandated by Congress for obtaining tax benefits that remain available. For example, the Committee intends that a restruc-

turing undertaken to transfer aircraft subject to existing FSC or ETI leases to a CFC lessor, to take advantange of the amendments made by this bill, would serve as a valid business purpose and would not constitute tax avoidance, for purposes of determining whether a particular tax treatment (such as nonrecognition of gain) applies to such restructuring. The Committee intends, for example, that if such a restructuring meets the other requirements necessary to qualify as a "reorganization" under section 368, the transaction will also be deemed to meet the "business purpose" requirements under section 368, and thus, qualify as a reorganization under that section.

EFFECTIVE DATE

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

## P. Modification of Exceptions Under Subpart F for Active Financing

(Sec. 316 of the bill and sec. 954 of the Code)

PRESENT LAW

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

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

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

country of organization is taxable as subpart F insurance income (Treas. Reg. sec. 1.953–1(a)).

Temporary exceptions from foreign personal holding company income, foreign base company services income, and insurance income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business (so-called "active financing income").[160]

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

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

REASONS FOR CHANGE

The Committee believes that the rules for determining whether income earned by an eligible CFC or QBU is active financing income should be more consistent with the rules for determining whether a CFC or QBU is eligible to earn active financing income.

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

EXPLANATION OF PROVISION

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

EFFECTIVE DATE

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

## TITLE IV—EXTENSION OF CERTAIN EXPIRING PROVISIONS

### A. Extend Alternative Minimum Tax Relief for Individuals

(Sec. 401 of the bill and sec. 26 of the Code)

PRESENT LAW

Present law provides for certain nonrefundable personal tax credits (i.e., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child tax credit,[161] the credit for interest on certain home mortgages, the HOPE Scholarship and Lifetime Learning credits, the IRA credit, and the D.C. homebuyer's credit).

For taxable years beginning in 2003, all the nonrefundable personal credits are allowed to the extent of the full amount of the individual's regular tax and alternative minimum tax.

For taxable years beginning after 2003, the credits (other than the adoption credit, child credit and IRA credit) are allowed only to the extent that the individual's regular income tax liability exceeds the individual's tentative minimum tax, determined without regard to the minimum tax foreign tax credit. The adoption credit, child credit, and IRA credit are allowed to the full extent of the individual's regular tax and alternative minimum tax.

[161] A portion of the child credit may be refundable.

The alternative minimum tax is the amount by which the tentative minimum tax exceeds the regular income tax. An individual's tentative minimum tax is an amount equal to (1) 26 percent of the first $175,000 ($87,500 in the case of a married individual filing a separate return) of alternative minimum taxable income ("AMTI") in excess of an exemption amount that phases out and (2) 28 percent of the remaining AMTI. The maximum tax rates on net capital gain used in computing the tentative minimum tax are the same as under the regular tax. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments. The exemption amounts are: (1) $58,000 ($45,000 in taxable years beginning after 2004) in the case of married individuals filing a joint return and surviving spouses; (2) $40,250 ($33,750 in taxable years beginning after 2004) in the case of other unmarried individuals; (3) $29,000 ($22,500 in taxable years beginning after 2004) in the case of married individuals filing a separate return; and (4) $22,500 in the case of an estate or trust. The exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) $150,000 in the case of married individuals filing a joint return and surviving spouses, (2) $112,500 in the case of other unmarried individuals, and (3) $75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

REASONS FOR CHANGE

The Committee believes that the nonrefundable personal credits should be useable without limitation by reason of the alternative minimum tax. This will result in significant simplification and will enable individuals to fully benefit from the credits.

EXPLANATION OF PROVISION

The bill extends the provision allowing an individual to offset the entire regular tax liability and alternative minimum tax liability by the personal nonrefundable credits for taxable years beginning in 2004 and 2005.

EFFECTIVE DATE

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

## B. Extension of the Research Credit

(Sec. 402 of the bill and sec. 41 of the Code)

PRESENT LAW

*General rule*

Section 41 provides for a research tax credit equal to 20 percent of the amount by which a taxpayer's qualified research expenses for a taxable year exceed its base amount for that year. The research tax credit is scheduled to expire and generally will not apply to amounts paid or incurred after June 30, 2004.

A 20-percent research tax credit also applies to the excess of (1) 100 percent of corporate cash expenses (including grants or con-

tributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations) over (2) the sum of (a) the greater of two minimum basic research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation. This separate credit computation is commonly referred to as the university basic research credit (see sec. 41(e)).

*Computation of allowable credit*

Except for certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenses for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's fixed-base percentage by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenses and had gross receipts during each of at least three years from 1984 through 1988, then its fixed-base percentage is the ratio that its total qualified research expenses for the 1984–1988 period bears to its total gross receipts for that period (subject to a maximum fixed-base percentage of 16 percent). All other taxpayers (so-called start-up firms) are assigned a fixed-base percentage of three percent. In computing the credit, a taxpayer's base amount may not be less than 50 percent of its current-year qualified research expenses.

*Alternative incremental research credit regime*

Taxpayers are allowed to elect an alternative incremental research credit regime.[162] If a taxpayer elects to be subject to this alternative regime, the taxpayer is assigned a three-tiered fixed-base percentage (that is lower than the fixed-base percentage otherwise applicable under present law) and the credit rate likewise is reduced. Under the alternative credit regime, a credit rate of 2.65 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of one percent (i.e., the base amount equals one percent of the taxpayer's average gross receipts for the four preceding years) but do not exceed a base amount computed by using a fixed-base percentage of 1.5 percent. A credit rate of 3.2 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1.5 percent but do not exceed a base amount computed by using a fixed-base percentage of two percent. A credit rate of 3.75 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of two percent. An election to be subject to this alternative incremental credit regime may be made for any taxable year beginning after June 30, 1996, and such an election applies to that taxable year and all subsequent years unless revoked with the consent of the Secretary of the Treasury.

[162] Sec. 41(c)(4).

*Eligible expenses*

Qualified research expenses eligible for the research tax credit consist of: (1) in-house expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of amounts paid or incurred by the taxpayer to certain other persons for qualified research conducted on the taxpayer's behalf (so-called contract research expenses).[163]

To be eligible for the credit, the research must not only satisfy the requirements of present-law section 174 (described below) but must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and substantially all of the activities of which must constitute elements of a process of experimentation for functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors (sec. 41(d)(3)). In addition, research does not qualify for the credit: (1) if conducted after the beginning of commercial production of the business component; (2) if related to the adaptation of an existing business component to a particular customer's requirements; (3) if related to the duplication of an existing business component from a physical examination of the component itself or certain other information; or (4) if related to certain efficiency surveys, management function or technique, market research, market testing, or market development, routine data collection or routine quality control (sec. 41(d)(4)). Research does not qualify for the credit if it is conducted outside the United States, Puerto Rico, or any U.S. possession.

*Relation to deduction*

Under section 174, taxpayers may elect to deduct currently the amount of certain research or experimental expenditures paid or incurred in connection with a trade or business, notwithstanding the general rule that business expenses to develop or create an asset that has a useful life extending beyond the current year must be capitalized.[164] However, deductions allowed to a taxpayer under section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year (Sec. 280C(c)). Taxpayers may alternatively elect to claim a reduced research tax credit amount under section 41 in lieu of reducing deductions otherwise allowed (sec. 280C(c)(3)).

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[163] Under a special rule enacted as part of the Small Business Job Protection Act of 1996, 75 percent of amounts paid to a research consortium for qualified research is treated as qualified research expenses eligible for the research credit (rather than 65 percent under the general rule under section 41(b)(3) governing contract research expenses) if (1) such research consortium is a tax-exempt organization that is described in section 501(c)(3) (other than a private foundation) or section 501(c)(6) and is organized and operated primarily to conduct scientific research, and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer. Sec. 41(b)(3)(C).

[164] Taxpayers may elect 10-year amortization of certain research expenditures allowable as a deduction under section 174(a). Secs. 174(f)(2) and 59(e).

REASONS FOR CHANGE

The Committee acknowledges that research is important to the economy. Research is the basis of new products, new services, new industries, and new jobs for the domestic economy. Therefore the Committee believes it is appropriate to extend the present-law research credit.

EXPLANATION OF PROVISION

The provision extends the present-law research credit to qualified amounts paid or incurred before January 1, 2006.

EFFECTIVE DATE

The provision is effective for amounts paid or incurred after June 30, 2004.

## C. Extension and Modification of the Section 45 Electricity Production Credit

(Sec. 403 of the bill and sec. 45 of the Code)

PRESENT LAW

An income tax credit is allowed for the production of electricity from either qualified wind energy, qualified "closed-loop" biomass, or qualified poultry waste facilities (sec. 45). The amount of the credit is 1.5 cents per kilowatt hour (indexed for inflation) of electricity produced. The amount of the credit is 1.8 cents per kilowatt hour for 2004. The credit is reduced for grants, tax-exempt bonds, subsidized energy financing, and other credits.

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

Closed-loop biomass is plant matter, where the plants are grown for the sole purpose of being used to generate electricity. It does not include waste materials (including, but not limited to, scrap wood, manure, and municipal or agricultural waste). The credit also is not available to taxpayers who use standing timber to produce electricity. Poultry waste means poultry manure and litter, including wood shavings, straw, rice hulls, and other bedding material for the disposition of manure.

The credit for electricity produced from wind, closed-loop biomass, or poultry waste is a component of the general business credit (sec. 38(b)(8)). The credit, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability above

$25,000, or (2) the tentative minimum tax. For credits arising in taxable years beginning after December 31, 1997, an unused general business credit generally may be carried back one year and carried forward 20 years (sec. 39). To coordinate the carryback with the period of application for this credit, the credit for electricity produced from closed-loop biomass facilities may not be carried back to a tax year ending before 1993 and the credit for electricity produced from wind energy may not be carried back to a tax year ending before 1994 (sec. 39).

REASONS FOR CHANGE

The Committee recognizes that the section 45 production credit has fostered additional electricity generation capacity in the form of non-polluting wind power. The Committee believes it is important to continue this tax credit by extending the placed in service date for such facilities to bring more wind energy to the U. S. electric grid. The Committee further believes that, to encourage entrepreneurial exploration of alternative sources for electricity generation, it is appropriate to extend the present-law provision relating to facilities that use closed-loop biomass as an energy source.

EXPLANATION OF PROVISION

The provision extends the placed in service date for wind facilities and closed-loop biomass facilities to facilities placed in service after December 31, 1993 (December 31, 1992 in the case of closed-loop biomass facilities) and before January 1, 2006. The provision does not extend the placed in service date for poultry waste facilities.

EFFECTIVE DATE

The provision is effective for facilities placed in service after December 31, 2003.

## D. Indian Employment Tax Credit

(Sec. 404 of the bill and sec. 45A of the Code)

PRESENT LAW

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

Qualified wages means wages paid or incurred by an employer for services performed by a qualified employee. A qualified employee means any employee who is an enrolled member of an Indian tribe or the spouse of an enrolled member of an Indian tribe,

who performs substantially all of the services within an Indian reservation, and whose principal place of abode while performing such services is on or near the reservation in which the services are performed. An employee will not be treated as a qualified employee for any taxable year of the employer if the total amount of wages paid or incurred by the employer with respect to such employee during the taxable year exceeds an amount determined at an annual rate of $30,000 (adjusted for inflation after 1993).

The wage credit is available for wages paid or incurred on or after January 1, 1994, in taxable years that begin before January 1, 2005.

REASONS FOR CHANGE

The Committee believes that extending the wage credit tax incentive will expand employment opportunities for members of Indian tribes.

EXPLANATION OF PROVISION

The provision extends the Indian employment credit incentive for one year (to taxable years beginning before January 1, 2006).

EFFECTIVE DATE

The provision is effective on the date of enactment.

## E. Extend the Work Opportunity Tax Credit

(Sec. 405 of the bill and sec. 51 of the Code)

PRESENT LAW

*In general*

The work opportunity tax credit ("WOTC") is available on an elective basis for employers hiring individuals from one or more of eight targeted groups. The credit equals 40 percent (25 percent for employment of 400 hours or less) of qualified wages. Generally, qualified wages are wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer.

The maximum credit per employee is $2,400 (40 percent of the first $6,000 of qualified first-year wages). With respect to qualified summer youth employees, the maximum credit is $1,200 (40 percent of the first $3,000 of qualified first-year wages).

For purposes of the credit, wages are generally defined as under the Federal Unemployment Tax Act, without regard to the dollar cap.

*Targeted groups eligible for the credit*

The eight targeted groups are: (1) families eligible to receive benefits under the Temporary Assistance for Needy Families ("TANF") Program; (2) high-risk youth; (3) qualified ex-felons; (4) vocational rehabilitation referrals; (5) qualified summer youth employees; (6) qualified veterans; (7) families receiving food stamps; and (8) persons receiving certain Supplemental Security Income ("SSI") benefits.

The employer's deduction for wages is reduced by the amount of the credit.

*Expiration date*

The credit is effective for wages paid or incurred to a qualified individual who begins work for an employer before January 1, 2004.

REASONS FOR CHANGE

The Committee believes that a temporary extension of this credit will allow the Congress and the Treasury and Labor Departments to continue to examine the effectiveness of the credit in expanding employment opportunities among the eight targeted groups.

EXPLANATION OF PROVISION

The bill extends the work opportunity tax credit for two years (through December 31, 2005).

EFFECTIVE DATE

The provision is effective for wages paid or incurred to a qualified individual who begins work for an employer on or after January 1, 2004, and before January 1, 2006.

## F. EXTEND THE WELFARE-TO-WORK TAX CREDIT

(Sec. 406 of the bill and sec. 51A of the Code)

PRESENT LAW

*In general*

The welfare-to-work tax credit is available on an elective basis for employers for the first $20,000 of eligible wages paid to qualified long-term family assistance recipients during the first two years of employment. The credit is 35 percent of the first $10,000 of eligible wages in the first year of employment and 50 percent of the first $10,000 of eligible wages in the second year of employment. The maximum credit is $8,500 per qualified employee.

Qualified long-term family assistance recipients are: (1) members of a family that has received family assistance for at least 18 consecutive months ending on the hiring date; (2) members of a family that has received family assistance for a total of at least 18 months (whether or not consecutive) after the date of enactment of this credit if they are hired within 2 years after the date that the 18–month total is reached; and (3) members of a family who are no longer eligible for family assistance because of either Federal or State time limits, if they are hired within two years after the Federal or State time limits made the family ineligible for family assistance. Family assistance means benefits under the Temporary Assistance to Needy Families ("TANF") program.

For purposes of the credit, wages are generally defined under the Federal Unemployment Tax Act, without regard to the dollar amount. In addition, wages include the following: (1) educational assistance excludable under a section 127 program; (2) the value of excludable health plan coverage but not more than the applicable

premium defined under section 4980B(f)(4); and (3) dependent care assistance excludable under section 129.

The employer's deduction for wages is reduced by the amount of the credit.

*Expiration date*

The welfare to work credit is effective for wages paid or incurred to a qualified individual who begins work for an employer before January 1, 2004.

REASONS FOR CHANGE

The Committee believes that the welfare-to-work credit should be temporarily extended to provide the Congress and Treasury and Labor Departments a better opportunity to continue to assess the operation and effectiveness of the credit in meeting its goals. These goals are: (1) to provide an incentive to hire long-term welfare recipients; (2) to promote the transition from welfare to work by increasing access to employment for these individuals; and (3) to encourage employers to provide these individuals with training, health coverage, dependent care and ultimately better job attachment.

EXPLANATION OF PROVISION

The bill extends the welfare to work credit for two years (through December 31, 2005).

EFFECTIVE DATE

The provision is effective for wages paid or incurred to a qualified individual who begins work for an employer on or after January 1, 2004, and before January 1, 2006.

## G. Extension of the Above-the-line Deduction for Certain Expenses of Elementary and Secondary School Teachers

(Sec. 407 of the bill and sec. 62 of the Code)

PRESENT LAW

In general, ordinary and necessary business expenses are deductible (sec. 162). However, in general, unreimbursed employee business expenses are deductible only as an itemized deduction and only to the extent that the individual's total miscellaneous deductions (including employee business expenses) exceed two percent of adjusted gross income. An individual's otherwise allowable itemized deductions may be further limited by the overall limitation on itemized deductions, which reduces itemized deductions for taxpayers with adjusted gross income in excess of $142,700 (for 2004). In addition, miscellaneous itemized deductions are not allowable under the alternative minimum tax.

Certain expenses of eligible educators are allowed as an above-the-line deduction. Specifically, for taxable years beginning in 2002 and 2003, an above-the-line deduction is allowed for up to $250 annually of expenses paid or incurred by an eligible educator for books, supplies (other than nonathletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services) and other equipment, and

supplementary materials used by the eligible educator in the classroom. To be eligible for this deduction, the expenses must be otherwise deductible under section 162 as a trade or business expense. A deduction is allowed only to the extent the amount of expenses exceeds the amount excludable from income under section 135 (relating to education savings bonds), 529(c)(1) (relating to qualified tuition programs), and section 530(d)(2) (relating to Coverdell education savings accounts).

An eligible educator is a kindergarten through grade 12 teacher, instructor, counselor, principal, or aide in a school for at least 900 hours during a school year. A school means any school that provides elementary education or secondary education, as determined under State law.

The above-the-line deduction for eligible educators is not allowed for taxable years beginning after December 31, 2003.

REASONS FOR CHANGE

The Committee recognizes that elementary and secondary educators often incur substantial unreimbursed expenses in the course of their teaching duties, and believes that an extension of the deduction of such expenses is warranted to continue to provide tax relief to educators who incur such expenses on behalf of their students.

EXPLANATION OF PROVISION

The provision extends the availability of the above-the-line deduction for two years, i.e., for taxable years beginning during 2004 and 2005.

EFFECTIVE DATE

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

## H. Extension of Accelerated Depreciation Benefit for Property on Indian Reservations

(Sec. 408 of the bill and sec. 168(j) of the Code)

PRESENT LAW

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

| | *Years* |
|---|---|
| 3-year property | 2 |
| 5-year property | 3 |
| 7-year property | 4 |
| 10-year property | 6 |
| 15-year property | 9 |
| 20-year property | 12 |
| Nonresidential real property | 22 |

"Qualified Indian reservation property" eligible for accelerated depreciation includes property which is (1) used by the taxpayer predominantly in the active conduct of a trade or business within an Indian reservation, (2) not used or located outside the reservation on a regular basis, (3) not acquired (directly or indirectly) by

the taxpayer from a person who is related to the taxpayer (within the meaning of section 465(b)(3)(C)), and (4) described in the recovery-period table above. In addition, property is not "qualified Indian reservation property" if it is placed in service for purposes of conducting gaming activities. Certain "qualified infrastructure property" may be eligible for the accelerated depreciation even if located outside an Indian reservation, provided that the purpose of such property is to connect with qualified infrastructure property located within the reservation (e.g., roads, power lines, water systems, railroad spurs, and communications facilities).

The depreciation deduction allowed for regular tax purposes is also allowed for purposes of the alternative minimum tax. The accelerated depreciation for Indian reservations is available with respect to property placed in service on or after January 1, 1994, and before January 1, 2005.

REASONS FOR CHANGE

The Committee believes that extending the depreciation incentive will encourage economic development within Indian reservations and expand employment opportunities on such reservations.

EXPLANATION OF PROVISION

The provision extends the accelerated depreciation incentive for one year (to property placed in service before January 1, 2006).

EFFECTIVE DATE

The provision is effective on the date of enactment.

## I. Extend Enhanced Charitable Deduction for Computer Technology and Equipment

(Sec. 409 of the bill and sec. 170 of the Code)

PRESENT LAW

Under present law, a taxpayer's deduction for charitable contributions of computer technology and equipment generally is limited to the taxpayer's basis (typically, cost) in the property. However, certain corporations may claim a deduction in excess of basis for a qualified computer contribution.[165] This enhanced deduction is equal to the lesser of (1) basis plus one-half of the item's appreciated value (i.e., basis plus one half of fair market value minus basis) or (2) two times basis. The enhanced deduction for qualified computer contributions expires for any contribution made during any taxable year beginning after December 31, 2003.

A qualified computer contribution means a charitable contribution of any computer technology or equipment that meets standards of functionality and suitability as established by the Secretary of the Treasury. The contribution must be to certain educational organizations or public libraries and made not later than three years after the taxpayer acquired the property or, if the taxpayer constructed the property, not later than the date construction of the

[165] Sec. 170(e)(6).

property is substantially completed.[166] The original use of the property must be by the donor or the donee,[167] and in the case of the donee, must be used substantially for educational purposes related to the function or purpose of the donee. The property must fit productively into the donee's education plan. The donee may not transfer the property in exchange for money, other property, or services, except for shipping, installation, and transfer costs. Property is considered constructed by the taxpayer only if the cost of the parts used in the construction of the property (other than parts manufactured by the taxpayer or a related person) does not exceed 50 percent of the taxpayer's basis in the property. Contributions may be made to private foundations under certain conditions.

REASONS FOR CHANGE

The Committee believes that educational organizations and public libraries continue to have a need for computer equipment and that it is appropriate to extend the enhanced deduction for contributions of such equipment to such institutions.

EXPLANATION OF PROVISION

The provision extends the enhanced deduction for qualified computer contributions to contributions made during any taxable year beginning before January 1, 2005.

EFFECTIVE DATE

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

## J. Extension of Expensing of Certain Environmental Remediation Costs

(Sec. 410 of the bill and sec. 198 of the Code)

PRESENT LAW

Taxpayers can elect to treat certain environmental remediation expenditures that would otherwise be chargeable to capital account as deductible in the year paid or incurred (sec. 198). The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site.

A "qualified contaminated site" generally is any property that (1) is held for use in a trade or business, for the production of income, or as inventory and (2) is at a site on which there has been a release (or threat of release) or disposal of certain hazardous substances as certified by the appropriate State environmental agency (so called "brownfields"). However, sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 cannot qualify as targeted areas.

[166] If the taxpayer constructed the property and reacquired such property, the contribution must be within three years of the date the original construction was substantially completed. Sec. 170(e)(6)(D)(i).

[167] This requirement does not apply if the property was reacquired by the manufacturer and contributed. Sec. 170(e)(6)(D)(ii).

Eligible expenditures are those paid or incurred before January 1, 2004.

REASONS FOR CHANGE

The Committee observes that by lowering the net capital cost of a development project the expensing of brownfields remediation costs promotes the goal of environmental remediation and promotes new investment and employment opportunities. In addition, the Committee believes that the increased investment in the qualifying areas has spillover effects that are beneficial to the neighboring communities. Therefore, the Committee believes it is appropriate to extend the present-law provision permitting the expensing of environmental remediation costs.

EXPLANATION OF PROVISION

The provision extends the present law expensing provision for two years (through December 31, 2005).

EFFECTIVE DATE

The provision is effective for expenses paid or incurred after December 31, 2003, and before January 1, 2006.

## K. EXTENSION OF ARCHER MEDICAL SAVINGS ACCOUNTS ("MSAS")

(Sec. 411 of the bill and sec. 220 of the Code)

PRESENT LAW

*In general*

Within limits, contributions to an Archer MSA are deductible in determining adjusted gross income if made by an eligible individual and are excludable from gross income and wages for employment tax purposes if made by the employer of an eligible individual. Earnings on amounts in an Archer MSA are not currently taxable. Distributions from an Archer MSA for medical expenses are not includible in gross income. Distributions not used for medical expenses are includible in gross income. In addition, distributions not used for medical expenses are subject to an additional 15-percent tax unless the distribution is made after age 65, death, or disability.

*Eligible individuals*

Archer MSAs are available to employees covered under an employer-sponsored high deductible plan of a small employer and self-employed individuals covered under a high deductible health plan.[168] An employer is a small employer if it employed, on average, no more than 50 employees on business days during either the preceding or the second preceding year. An individual is not eligible for an Archer MSA if he or she is covered under any other health plan in addition to the high deductible plan.

[168] Self-employed individuals include more than two-perent shareholders of S corporations who are treated as partners for purposes of fringe benefit rules pursuant to section 1372.

*Tax treatment of and limits on contributions*

Individual contributions to an Archer MSA are deductible (within limits) in determining adjusted gross income (i.e., "above-the-line"). In addition, employer contributions are excludable from gross income and wages for employment tax purposes (within the same limits), except that this exclusion does not apply to contributions made through a cafeteria plan. In the case of an employee, contributions can be made to an Archer MSA either by the individual or by the individual's employer.

The maximum annual contribution that can be made to an Archer MSA for a year is 65 percent of the deductible under the high deductible plan in the case of individual coverage and 75 percent of the deductible in the case of family coverage.

*Definition of high deductible plan*

A high deductible plan is a health plan with an annual deductible of at least $1,700 and no more than $2,600 in the case of individual coverage and at least $3,450 and no more than $5,150 in the case of family coverage. In addition, the maximum out-of-pocket expenses with respect to allowed costs (including the deductible) must be no more than $3,450 in the case of individual coverage and no more than $6,300 in the case of family coverage.[169] A plan does not fail to qualify as a high deductible plan merely because it does not have a deductible for preventive care as required by State law. A plan does not qualify as a high deductible health plan if substantially all of the coverage under the plan is for permitted coverage (as described above). In the case of a self-insured plan, the plan must in fact be insurance (e.g., there must be appropriate risk shifting) and not merely a reimbursement arrangement.

*Cap on taxpayers utilizing Archer MSAs and expiration of pilot program*

The number of taxpayers benefiting annually from an Archer MSA contribution is limited to a threshold level (generally 750,000 taxpayers). The number of Archer MSAs established has not exceeded the threshold level.

After 2003, no new contributions may be made to Archer MSAs except by or on behalf of individuals who previously had Archer MSA contributions and employees who are employed by a participating employer.

Trustees of Archer MSAs are generally required to make reports to the Treasury by August 1 regarding Archer MSAs established by July 1 of that year. If any year is a cut-off year, the Secretary is required to make and publish such determination by October 1 of such year.

REASONS FOR CHANGE

The Committee believes that individuals should be encouraged to save for future medical care expenses and that individuals should be allowed to save for such expenses on a tax-favored basis. The Committee believes that consumers who spend their own savings on health care will make cost-conscious decisions, thus reducing

[169] These dollar amounts are for 2004. These amounts are indexed for inflation, rounded to the nearest $50.

the rising cost of health care. The Committee believes that Archer MSAs have been an important tool in allowing certain individuals to save for future medical expenses on a tax-favored basis.

The Committee is aware that recently enacted health savings accounts offer more advantageous tax treatment than Archer MSAs and that amounts can be rolled over into a health savings account from an Archer MSA on a tax-free basis. Still, the Committee believes that individuals should be allowed the choice to continue the use of Archer MSAs. Thus, the Committee believes that it is appropriate to extend Archer MSAs.

EXPLANATION OF PROVISION

The provision extends Archer MSAs through December 31, 2005. The provision also provides that the reports required by MSA trustees for 2004 are treated as timely if made within 90 days after the date of enactment. In addition, the determination of whether 2004 is a cut-off year and the publication of such determination is to be made within 120 days of the date of enactment. If 2004 is a cut-off year, the cut-off date will be the last day of such 120-day period.

EFFECTIVE DATE

The provision is generally effective on January 1, 2004. The provisions relating to reports and the determination by the Secretary are effective on the date of enactment.

## L. Taxable Income Limit on Percentage Depletion for Oil and Natural Gas Produced From Marginal Properties

(Sec. 412 of the bill and sec. 613A of the Code)

PRESENT LAW

*Overview of depletion*

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

Depletion is available to any person having an economic interest in a producing property. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in minerals in place, and secures, by any form of legal relationship, income derived from the extraction of the mineral, to which it must look for a return of its capital.[170] Thus, for example, both working interests and royalty interests in an oil- or gas-producing property constitute economic interests, thereby qualifying the interest holders for depletion deductions with respect to the property. A taxpayer who has no capital investment in the mineral deposit does not possess an economic interest merely because it possesses an

[170] Treas. Reg. sec. 1.611–1(b)(1).

economic or pecuniary advantage derived from production through a contractual relation.

*Cost depletion*

Two methods of depletion are currently allowable under the Code: (1) the cost depletion method, and (2) the percentage depletion method.[171] Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the depletable property which is equal to the ratio of units sold from that property during the taxable year to the number of units remaining as of the end of taxable year plus the number of units sold during the taxable year. Thus, the amount recovered under cost depletion may never exceed the taxpayer's basis in the property.

*Percentage depletion and related income limitations*

The Code generally limits the percentage depletion method for oil and gas properties to independent producers and royalty owners.[172] Generally, under the percentage depletion method, 15 percent of the taxpayer's gross income from an oil- or gas-producing property is allowed as a deduction in each taxable year.[173] The amount deducted generally may not exceed 100 percent of the net income from that property in any year (the "net-income limitation").[174] The 100-percent net-income limitation for marginal wells has been suspended for taxable years beginning after December 31, 1997, and before January 1, 2004.

REASONS FOR CHANGE

Domestic production from marginal wells is an appropriate part of establishing national energy security and reducing dependence on foreign oil. The Committee believes the suspension of the 100-percent net-income limitation for marginal wells should be extended to encourage continued operation of such wells.

EXPLANATION OF PROVISION

The suspension of the 100-percent net-income limitation for marginal wells is extended an additional two years, through taxable years beginning before January 1, 2006.

EFFECTIVE DATE

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

## M. Qualified Zone Academy Bonds

(Sec. 413 of the bill and sec. 1397E of the Code)

PRESENT LAW

*Tax-exempt bonds*

Interest on State and local governmental bonds generally is excluded from gross income for Federal income tax purposes if the

[171] Secs. 611–613.
[172] Sec. 613A.
[173] Sec. 613A(c).
[174] Sec. 613(a).

proceeds of the bonds are used to finance direct activities of these governmental units or if the bonds are repaid with revenues of the governmental units. Activities that can be financed with these tax-exempt bonds include the financing of public schools (sec. 103).

*Qualified zone academy bonds*

As an alternative to traditional tax-exempt bonds, States and local governments are given the authority to issue "qualified zone academy bonds" ("QZABs") (sec. 1397E). A total of $400 million of qualified zone academy bonds may be issued annually in calendar years 1998 through 2003. The $400 million aggregate bond cap is allocated each year to the States according to their respective populations of individuals below the poverty line. Each State, in turn, allocates the credit authority to qualified zone academies within such State.

Financial institutions that hold qualified zone academy bonds are entitled to a nonrefundable tax credit in an amount equal to a credit rate multiplied by the face amount of the bond. A taxpayer holding a qualified zone academy bond on the credit allowance date is entitled to a credit. The credit is includable in gross income (as if it were a taxable interest payment on the bond), and may be claimed against regular income tax and AMT liability.

The Treasury Department sets the credit rate at a rate estimated to allow issuance of qualified zone academy bonds without discount and without interest cost to the issuer. The maximum term of the bond is determined by the Treasury Department, so that the present value of the obligation to repay the bond is 50 percent of the face value of the bond.

"Qualified zone academy bonds" are defined as any bond issued by a State or local government, provided that: (1) at least 95 percent of the proceeds are used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a "qualified zone academy", and (2) private entities have promised to contribute to the qualified zone academy certain equipment, technical assistance or training, employee services, or other property or services with a value equal to at least 10 percent of the bond proceeds.

A school is a "qualified zone academy" if: (1) the school is a public school that provides education and training below the college level, (2) the school operates a special academic program in cooperation with businesses to enhance the academic curriculum and increase graduation and employment rates, and (3) either (a) the school is located in an empowerment zone or enterprise community designated under the Code, or (b) it is reasonably expected that at least 35 percent of the students at the school will be eligible for free or reduced-cost lunches under the school lunch program established under the National School Lunch Act.

REASONS FOR CHANGE

The Committee believes that the extension of authority to issue qualified zone academy bonds is appropriate in light of the educational needs that exist today.

EXPLANATION OF PROVISION

The bill authorizes issuance of up to $400 million of qualified zone academy bonds annually for calendar years 2004 and 2005.

EFFECTIVE DATE

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

## N. Extension of Tax Incentives for Investment in the District of Columbia

(Sec. 414 of the bill and secs. 1400, 1400A, 1400B, and 1400C of the Code)

PRESENT LAW

*DC Zone incentives*

The Taxpayer Relief Act of 1997 designated certain economically depressed census tracts within the District of Columbia as the District of Columbia Enterprise Zone (the "D.C. Zone"), within which businesses and individual residents are eligible for special tax incentives. The D.C. Zone designation is in effect for the period from January 1, 1998, through December 31, 2003. In addition to the tax incentives generally available with respect to empowerment zones, the D.C. Zone also has a zero-percent capital gains rate that applies to gain from the sale of certain qualified D.C. Zone assets acquired after December 31, 1997, and held for more than five years.

With respect to the tax-exempt financing incentives, the D.C. Zone generally is treated like a Round I empowerment zone; therefore, the issuance of such tax-exempt bonds is subject to the District of Columbia's annual private activity bond volume limitation. However, the aggregate face amount of all outstanding qualified D.C. zone facility bonds per qualified D.C. Zone business may not exceed $15 million (rather than $3 million, as is the case for Round I empowerment zones).

*Homebuyers tax credit*

First-time homebuyers of a principal residence in the District of Columbia are eligible for a nonrefundable tax credit of up to $5,000 of the amount of the purchase price. The $5,000 maximum credit applies both to individuals and married couples. Married individuals filing separately can claim a maximum credit of $2,500 each. The credit phases out for individual taxpayers with adjusted gross income between $70,000 and $90,000 ($110,000–$130,000 for joint filers). For purposes of eligibility, "first-time homebuyer" means any individual if such individual did not have a present ownership interest in a principal residence in the District of Columbia in the one-year period ending on the date of the purchase of the residence to which the credit applies. The credit is scheduled to expire for property purchased after December 31, 2003.

REASONS FOR CHANGE

The Committee believes that the incentives should temporarily be extended to provide the Congress and the Treasury Department a better opportunity to continue to assess the overall operation and

effectiveness of the tax incentives to revitalize the DC Zone and to promote homeownership therein.

EXPLANATION OF PROVISION

*DC Zone incentives*

The bill extends the D.C. Zone designation and tax-exempt financing incentives for two years (through December 31, 2005). The bill extends the date before which a DC Zone asset must be acquired for purposes of utilizing the zero-percent capital gains rate for two years (to January 1, 2006), and extends the period within which gain is treated as qualified capital gain for two years (through December 31, 2010).

*Homebuyers tax credit*

The bill extends the first-time homebuyer credit for two years (through December 31, 2005).

EFFECTIVE DATE

The provisions are effective on the date of enactment, except that the provision relating to tax-exempt financing incentives applies to obligations issued after December 31, 2003.

## O. Extend the Authority to Issue Liberty Zone Bonds

(Sec. 415 of the bill and sec. 1400L of the Code)

PRESENT LAW

*In general*

Interest on debt incurred by States or local governments is excluded from income if the proceeds of the borrowing are used to carry out governmental functions of those entities or the debt is repaid with governmental funds (sec. 103). Interest on bonds that nominally are issued by States or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private person is taxable unless the purpose of the borrowing is approved specifically in the Code or in a non-Code provision of a revenue Act. These bonds are called "private activity bonds." The term "private person" includes the Federal Government and all other individuals and entities other than States or local governments.

In most cases, the aggregate volume of tax-exempt private activity bonds that may be issued in a State is restricted by annual volume limits. For calendar year 2004, these annual volume limits are equal to the greater of $80 per resident of the State or $234 million.

*Tax-exempt private activity bonds*

Interest on private activity bonds is tax-exempt only for qualified bonds. Qualified bonds include: (1) exempt facility bonds; (2) qualified mortgage bonds; (3) qualified veteran mortgage bonds; (4) qualified small-issue bonds; (5) qualified student loan bonds; (6) qualified redevelopment bonds; and (7) qualified 501(c)(3) bonds. A further provision allows tax-exempt financing for "environmental enhancements of hydro-electric generating facilities." Tax-exempt

financing also is authorized for capital expenditures for small manufacturing facilities and land and equipment for first-time farmers ("qualified small-issue bonds"), local redevelopment activities ("qualified redevelopment bonds"), and eligible empowerment zone and enterprise community businesses.

Tax-exempt financing is also allowed for qualified New York Liberty Bonds issued during calendar years 2002, 2003, and 2004. An aggregate limit of $8 billion of tax-exempt private activity bonds to finance the construction and rehabilitation of nonresidential real property[175] and residential rental real property[176] in a newly designated "Liberty Zone" (the "Zone") of New York City is allowed.[177] Property eligible for financing with these bonds includes buildings and their structural components, fixed tenant improvements,[178] and public utility property (e.g., gas, water, electric and telecommunication lines). All business addresses located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan are considered to be located within the Zone. Issuance of these bonds is limited to projects approved by the Mayor of New York City or the Governor of New York State, each of whom may designate up to $4 billion of the bonds authorized under the bill.

If the Mayor or the Governor determines that it is not feasible to use all of the authorized bonds that he is authorized to designate for property located in the Zone, up to $1 billion of bonds may be designated by each to be used for the acquisition, construction, and rehabilitation of nonresidential real property (including fixed tenant improvements) located outside the Zone and within New York City.[179] Bond-financed property located outside the Zone must meet the additional requirement that the project have at least 100,000 square feet of usable office or other commercial space in a single building or multiple adjacent buildings.

Subject to the following exceptions and modifications, issuance of these tax-exempt bonds is subject to the general rules applicable to issuance of exempt-facility private activity bonds:

(1) Issuance of the bonds is not subject to the aggregate annual State private activity bond volume limits (sec. 146);

(2) The restriction on acquisition of existing property is applied using a minimum requirement of 50 percent of the cost

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[175] No more than $800 million of the authorized bond amount may be used to finance property used for retail sales of tangible property (e.g., department stores, restaurants, etc.) and functionally related and subordinate property. The term nonresidential real property includes structural components of such property if the taxpayer treats such components as part of the real property structure for all Federal income tax purposes (e.g., cost recovery). The $800 million limit is divided equally between the Mayor and the Governor.

[176] No more than $1.6 billion of the authorized bond amount may be used to finance residential rental property. The $1.6 billion limit is divided equally between the Mayor and the Governor.

[177] Current refundings of outstanding New York Liberty Bonds bonds do not count against the $8 billion volume limit to the extent that the amount of the refunding bonds does not exceed the outstanding amount of the bonds being refunded. In addition, qualified New York Liberty Bonds may be issued after December 31, 2004 to refund (other than advance refund) qualified New York Liberty Bonds originally issued before January 1, 2005, to the extent the amount of the refunding bonds does not exceed the outstanding amount of the refunded bonds. The bonds may not be advance refunded.

[178] Fixtures and equipment that could be removed from the designated zone for use elsewhere are not eligible for financing with these bonds.

[179] Public utility property and residential property located outside the Zone cannot be financed with the bonds.

of acquiring the building being devoted to rehabilitation (sec. 147(d));

(3) The special arbitrage expenditure rules for certain construction bond proceeds apply to available construction proceeds of the bonds (sec. 148(f)(4)(C));

(4) The tenant targeting rules applicable to exempt-facility bonds for residential rental property (and the corresponding change in use penalties for violations of those rules) do not apply to such property financed with the bonds (secs. 142(d) and 150(b)(2));

(5) Repayments of bond-financed loans may not be used to make additional loans, but rather must be used to retire outstanding bonds (with the first such retirement occurring 10 years after issuance of the bonds);[180] and

(6) Interest on the bonds is not a preference item for purposes of the alternative minimum tax preference for private activity bond interest (sec. 57(a)(5)).

REASONS FOR CHANGE

The Committee is committed to aiding the City of New York's economic recovery from the terrorist attacks of September 11, 2001. Therefore, the Committee believes that an extension of the authority to issue New York Liberty Bonds is appropriate.

EXPLANATION OF PROVISION

The bill extends authority to issue New York Liberty Bonds through December 31, 2009.

EFFECTIVE DATE

The provision is effective for bonds issued after the date of enactment and before January 1, 2010.

## P. Disclosure to Law Enforcement Agencies Regarding Terrorist Activities

(Sec. 416 of the bill and sec. 6103 of the Code)

PRESENT LAW

Return information includes a taxpayer's identity.[181] The IRS may disclose return information, other than taxpayer return information, to officers and employees of Federal law enforcement upon a written request. The request must be made by the head of the Federal law enforcement agency (or his delegate) involved in the response to or investigation of terrorist incidents, threats, or activities, and set forth the specific reason or reasons why such disclosure may be relevant to a terrorist incident, threat, or activity. The information is to be disclosed to officers and employees of the Federal law enforcement agency who would be personally and directly involved in the response to or investigation of terrorist incidents,

[180] It is intended that redemptions will occur at least semi-annually beginning at the end of 10 years after the bonds are issued; however, amounts less than $250,000 are not required to be used to redeem bonds at such intervals.

[181] Sec. 6103(b)(2)(A).

threats, or activities. The information is to be used by such officers and employees solely for such response or investigation.[182]

The Federal law enforcement agency may redisclose the information to officers and employees of State and local law enforcement personally and directly engaged in the response to or investigation of the terrorist incident, threat, or activity. The State or local law enforcement agency must be part of an investigative or response team with the Federal law enforcement agency for these disclosures to be made.[183]

If a taxpayer's identity is taken from a return or other information filed with or furnished to the IRS by or on behalf of the taxpayer, it is taxpayer return information. Since taxpayer return information is not covered by this disclosure authorization, taxpayer identity so obtained cannot be disclosed and thus associated with the other information being provided.

The Code also allows the IRS to disclose return information (other than taxpayer return information) upon the written request of an officer or employee of the Department of Justice or Treasury who is appointed by the President with the advice and consent of the Senate, or who is the Director of the U.S. Secret Service, if such individual is responsible for the collection and analysis of intelligence and counterintelligence concerning any terrorist incident, threat, or activity.[184] Taxpayer identity information for this purpose is not considered taxpayer return information. Such written request must set forth the specific reason or reasons why such disclosure may be relevant to a terrorist incident, threat, or activity. Disclosures under this authority may be made to those officers and employees of the Department of Justice, Treasury, and Federal intelligence agencies who are personally and directly engaged in the collection or analysis of intelligence and counterintelligence information or investigation concerning any terrorist incident, threat, or activity. Such disclosures may be made solely for the use of such officers and employees in such investigation, collection, or analysis.

The IRS, on its own initiative, may disclose in writing return information (other than taxpayer return information) that may be related to a terrorist incident, threat, or activity to the extent necessary to apprise the head of the appropriate investigating Federal law enforcement agency.[185] Taxpayer identity information for this purpose is not considered taxpayer return information. The head of the agency may redisclose such information to officers and employees of such agency to the extent necessary to investigate or respond to the terrorist incident, threat, or activity.

If taxpayer return information is sought, the disclosure must be made pursuant to the ex parte order of a Federal district court judge or magistrate.

No disclosures may be made under these provisions after December 31, 2003.

REASONS FOR CHANGE

The Committee believes that a renewal of this disclosure authority will provide additional time to evaluate the effectiveness of the

[182] Sec. 6103(i)(7)(A).
[183] Sec. 6103(i)(7)(A)(ii).
[184] Sec. 6103(i)(7)(B).
[185] Sec. 6103(i)(3)(C).

provision and whether any modifications need to be implemented to enhance the provision.

EXPLANATION OF PROVISION

The provision extends the disclosure authority relating to terrorist activities. Under the provision, no disclosures can be made after December 31, 2005.

The provision also makes a technical change to clarify that a taxpayer's identity is not treated as taxpayer return information for purposes of disclosures to law enforcement agencies regarding terrorist activities.

EFFECTIVE DATE

The provision extending authority is effective for disclosures made on or after the date of enactment. The technical change is effective as if included in section 201 of the Victims of Terrorism Tax Relief Act of 2001.

## Q. Disclosure of Return Information Relating to Student Loans

(Sec. 417 of the bill and sec. 6103(l) of the Code)

PRESENT LAW

Present law prohibits the disclosure of returns and return information, except to the extent specifically authorized by the Code.[186] An exception is provided for disclosure to the Department of Education (but not to contractors thereof) of a taxpayer's filing status, adjusted gross income and identity information (i.e., name, mailing address, taxpayer identifying number) to establish an appropriate repayment amount for an applicable student loan.[187] The Department of Education disclosure authority is scheduled to expire after December 31, 2004.[188]

An exception to the general rule prohibiting disclosure is also provided for the disclosure of returns and return information to a designee of the taxpayer.[189] Unlike the specific Department of Education exception, section 6103(c) disclosures are not subject to use restrictions nor are they subject to statutory safeguards. Because the Department of Education utilizes contractors for the income-contingent loan verification program, the Department of Education obtains taxpayer information by consent under section 6103(c), rather than under the specific exception.[190] The Department of Treasury has reported that the Internal Revenue Service processes approximately 100,000 consents per year for this purpose.[191]

REASONS FOR CHANGE

The Committee believes that the Department of Education should be provided with access to tax return information to assist

[186] Sec. 6103.
[187] Sec. 6103(l)(13).
[188] Pub. L. No. 108–89, sec. 201 (2003).
[189] Sec. 6103(c).
[190] Department of Treasury, Report to the Congress on Scope and Use of Taxpayer Confidentiality and Disclosure Provisions, Volume I: Study of General Provisions (October 2000) at 91.
[191] Department of Treasury, General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals (February 2003) at 133.

it in carrying out the income-contingent repayment program. Thus, the Committee believes that it is appropriate to provide a further extension of this disclosure authority.

EXPLANATION OF PROVISION

The bill extends the disclosure authority relating to the disclosure of return information to carry out income-contingent repayment of student loans. Under the bill, no disclosures can be made after December 31, 2005.

EFFECTIVE DATE

The provision is effective with respect to disclosures made after the date of enactment.

## R. Extension of Cover Over of Excise Tax on Distilled Spirits to Puerto Rico and Virgin Islands

(Sec. 418 of the bill and sec. 7652 of the Code)

PRESENT LAW

A $13.50 per proof gallon[192] excise tax is imposed on distilled spirits produced in or imported (or brought) into the United States.[193] The excise tax does not apply to distilled spirits that are exported from the United States, including exports to U.S. possessions (e.g., Puerto Rico and the Virgin Islands).[194]

The Code provides for cover over (payment) to Puerto Rico and the Virgin Islands of the excise tax imposed on rum imported (or brought) into the United States, without regard to the country of origin.[195] The amount of the cover over is limited under section 7652(f) to $10.50 per proof gallon ($13.25 per proof gallon during the period July 1, 1999 through December 31, 2003).

Thus, tax amounts attributable to shipments to the United States of rum produced in Puerto Rico are covered over to Puerto Rico. Tax amounts attributable to shipments to the United States of rum produced in the Virgin Islands are covered over to the Virgin Islands. Tax amounts attributable to shipments to the United States of rum produced in neither Puerto Rico nor the Virgin Islands are divided and covered over to the two possessions under a formula.[196] Amounts covered over to Puerto Rico and the Virgin Islands are deposited into the treasuries of the two possessions for use as those possessions determine.[197] All of the amounts covered over are subject to the limitation.

REASONS FOR CHANGE

The Committee believes that the needs of Puerto Rico and the Virgin Islands justify the extension of the cover over amount of $13.25 per proof gallon through December 31, 2005.

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[192] A proof gallon is a liquid gallon consisting of 50 percent alcohol. See sec. 5002(a)(10), (11).
[193] Sec. 5001(a)(1).
[194] Secs. 5062(b), 7653(b) and (c).
[195] Sec. 7652(a)(3), (b)(3), and (e)(1). One percent of the amount of excise tax collected from imports into the United States of articles produced in the Virgin Islands is retained by the United States under section 7652(b)(3).
[196] Sec. 7652(e)(2).
[197] Sec. 7652(a)(3), (b)(3), and (e)(1).

EXPLANATION OF PROVISION

The provision temporarily suspends the $10.50 per proof gallon limitation on the amount of excise taxes on rum covered over to Puerto Rico and the Virgin Islands. Under the provision, the cover over amount of $13.25 per proof gallon is extended for rum brought into the United States after December 31, 2003 and before January 1, 2006. After December 31, 2005, the cover over amount reverts to $10.50 per proof gallon.

EFFECTIVE DATE

The provision is effective for articles brought into the United States after December 31, 2003.

## S. Extension of Joint Review

(Sec. 419 of the bill and secs. 8021 and 8022 of the Code)

PRESENT LAW

The Code required the Joint Committee on Taxation to conduct a joint review[198] of the strategic plans and budget of the IRS from 1999 through 2003.[199] The Code also required the Joint Committee to provide an annual report[200] from 1999 through 2003 with respect to:

- Strategic and business plans for the IRS;
- Progress of the IRS in meeting its objectives;
- The budget for the IRS and whether it supports its objectives;
- Progress of the IRS in improving taxpayer service and compliance;
- Progress of the IRS on technology modernization; and
- The annual filing season.

REASONS FOR CHANGE

The Committee believes that a joint review of the IRS should be held for one additional year and that the report provided by the Joint Committee on Taxation should be tailored to the specific issues addressed in the joint review.

EXPLANATION OF PROVISION

The provision requires that the Joint Committee conduct a joint review before June 1, 2005. The provision requires the Joint Committee to provide an annual report before June 1, 2005, but specifies that the content of the annual report is the matters addressed in the joint review.[201]

EFFECTIVE DATE

The provision is effective on the date of enactment.

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[198] The joint review was required to include two members of the majority and one member of the minority of the Senate Committees on Finance, Appropriations, and Governmental Affairs, and of the House Committees on Ways and Means, Appropriations, and Government Reform and Oversight.

[199] Sec. 8021(f).

[200] Sec. 8022(3)(C).

[201] Accordingly, the provision deletes the specific list of matters required to be covered in the annual report.

## T. Parity in the Application of Certain Limits to Mental Health Benefits

(Sec. 420 of the bill and sec. 9812 of the Code)

### PRESENT LAW

The Mental Health Parity Act of 1996 amended the Employee Retirement Income Security Act of 1974 ("ERISA") and the Public Health Service Act ("PHSA") to provide that group health plans that provide both medical and surgical benefits and mental health benefits cannot impose aggregate lifetime or annual dollar limits on mental health benefits that are not imposed on substantially all medical and surgical benefits. The provisions of the Mental Health Parity Act were initially effective with respect to plan years beginning on or after January 1, 1998, for a temporary period. Since enactment, the mental health parity requirements in ERISA and the PHSA have been extended on more than one occasion and currently are scheduled to expire with respect to benefits for services furnished on or after December 31, 2004.

The Taxpayer Relief Act of 1997 added to the Code the requirements imposed under the Mental Health Parity Act, and imposed an excise tax on group health plans that fail to meet the requirements. The excise tax is equal to $100 per day during the period of noncompliance and is generally imposed on the employer sponsoring the plan if the plan fails to meet the requirements. The maximum tax that can be imposed during a taxable year cannot exceed the lesser of 10 percent of the employer's group health plan expenses for the prior year or $500,000. No tax is imposed if the Secretary determines that the employer did not know, and exercising reasonable diligence would not have known, that the failure existed.

The Code provisions were initially effective with respect to plan years beginning on or after January 1, 1998, for a temporary period.[202] The Code provisions have been extended on a number of occasions, and expired with respect to benefits for services furnished after December 31, 2003.

### REASONS FOR CHANGE

The provisions of the Mental Health Parity Act in ERISA and the PHSA have been extended to December 31, 2004, while the Code provisions have expired. The Committee recognizes that the Code provisions relating to mental health parity are important to carrying out the purposes of the Mental Health Parity Act. Thus, the Committee believes that extending the Code provisions relating to mental health parity is warranted.

### EXPLANATION OF PROVISION

The provision extends the Code provisions relating to mental health parity to benefits for services furnished after the date of enactment and before January 1, 2006. Thus, the excise tax on failures to meet the requirements imposed by the Code provisions does

[202] The excise tax does not apply to benefits for services furnished on or after September 30, 2001, and before January 10, 2002.

not apply after December 31, 2003, and before the date of enactment.

EFFECTIVE DATE

The provision is effective for benefits for services furnished after the date of enactment.

## U. Disclosure of Tax Information To Facilitate Combined Employment Tax Reporting

(Sec. 421 of the bill)

PRESENT LAW

Traditionally, Federal tax forms are filed with the Federal government and State tax forms are filed with individual States. This necessitates duplication of items common to both returns.

The Taxpayer Relief Act of 1997[203] permitted implementation of a demonstration project to assess the feasibility and desirability of expanding combined Federal and State reporting. There were several limitations on the demonstration project. First, it was limited to the sharing of information between the State of Montana and the IRS. Second, it was limited to employment tax reporting. Third, it was limited to disclosure of the name, address, TIN, and signature of the taxpayer, which is information common to both the Montana and Federal portions of the combined form. Fourth, it was limited to a period of five years.

The authority for the demonstration project expired on the date five years after the date of enactment (August 5, 2002).

REASONS FOR CHANGE

The Committee believes that authorizing this pilot project for an additional year will provide the Congress with information to assess the usefulness of the program and whether further expansions are warranted.

EXPLANATION OF PROVISION

The provision renews authority for the demonstration project through December 31, 2005.

EFFECTIVE DATE

The provision is effective on the date of enactment.

## V. Extension of Tax Credit for Electric Vehicles and Tax Deduction for Clean-Fuel Vehicles

(Sec. 422 of the bill and secs. 30 and 179A of the Code)

PRESENT LAW

*Electric vehicles*

A 10-percent tax credit is provided for the cost of a qualified electric vehicle, up to a maximum credit of $4,000 (sec. 30). A qualified electric vehicle is a motor vehicle that is powered primarily by an electric motor drawing current from rechargeable batteries, fuel

[203] Pub. L. No. 105–34, sec. 976.

cells, or other portable sources of electrical current, the original use of which commences with the taxpayer, and that is acquired for the use by the taxpayer and not for resale. The full amount of the credit is available for purchases prior to 2002. The credit phases down in the years 2004 through 2006, and is unavailable for purchases after December 31, 2006.

*Clean-fuel vehicles*

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

REASONS FOR CHANGE

The Committee believes it is necessary to continue to provide the full benefit of the tax subsidy to the purchase of these innovative vehicles to enable such vehicles to demonstrate their road-worthiness to the consumer.

EXPLANATION OF PROVISION

The provision suspends the phase down of allowable tax credit for electric vehicles and the deduction for clean-fuel vehicles in 2004 and 2005. Thus, a taxpayer who purchases a qualifying vehicle may claim 100 percent of the otherwise allowable credit or deduction for vehicles purchased in 2004 and 2005. For vehicles purchased in 2006 the credit or deduction remains at 25 percent of the otherwise allowable amount as under present law.

EFFECTIVE DATE

The provision is effective for vehicles placed in service after December 31, 2003.

## TITLE V—DEDUCTION OF STATE AND LOCAL GENERAL SALES TAXES

### A. Deduction of State and Local General Sales Taxes

(Sec. 501 of the bill and sec. 164 of the Code)

PRESENT LAW

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

REASONS FOR CHANGE

The Committee recognizes that not all States rely on income taxes as a primary source of revenue, and that allowing a deduction for State and local income taxes, but not sales taxes, may create inequities across States and may also create bias in the types of taxes that States and localities choose to impose. The Committee believes that the provision of an itemized deduction for State and local general sales taxes in lieu of the deduction for State and local income taxes provides more equitable Federal tax treatment across States, and will cause the Federal tax laws to have a more neutral effect on the types of taxes that State and local governments utilize.

EXPLANATION OF PROVISION

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

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

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

EFFECTIVE DATE

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

# TITLE VI—REVENUE PROVISIONS

## A. Provisions To Reduce Tax Avoidance Through Individual and Corporate Expatriation

### 1. Tax treatment of expatriated entities and their foreign parents (sec. 601 of the bill and new sec. 7874 of the Code)

PRESENT LAW

*Determination of corporate residence*

The U.S. tax treatment of a multinational corporate group depends significantly on whether the parent corporation of the group is domestic or foreign. For purposes of U.S. tax law, a corporation is treated as domestic if it is incorporated under the law of the United States or of any State. All other corporations (i.e., those incorporated under the laws of foreign countries) are treated as foreign.

*U.S. taxation of domestic corporations*

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

Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income generally is deferred, and U.S. tax is imposed on such income when repatriated. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F (secs. 951–964) and the passive foreign investment company rules (secs. 1291–1298). A foreign tax credit is generally available to offset, in whole or in part, the U.S. tax owed on this foreign-source income, whether repatriated as an actual dividend or included under one of the anti-deferral regimes.

*U.S. taxation of foreign corporations*

The United States taxes foreign corporations only on income that has a sufficient nexus to the United States. Thus, a foreign corporation is generally subject to U.S. tax only on income that is "effectively connected" with the conduct of a trade or business in the United States. Such "effectively connected income" generally is taxed in the same manner and at the same rates as the income of a U.S. corporation. An applicable tax treaty may limit the imposition of U.S. tax on business operations of a foreign corporation to

cases in which the business is conducted through a "permanent establishment" in the United States.

In addition, foreign corporations generally are subject to a gross-basis U.S. tax at a flat 30-percent rate on the receipt of interest, dividends, rents, royalties, and certain similar types of income derived from U.S. sources, subject to certain exceptions. The tax generally is collected by means of withholding by the person making the payment. This tax may be reduced or eliminated under an applicable tax treaty.

*U.S. tax treatment of inversion transactions*

Under present law, a U.S. corporation may reincorporate in a foreign jurisdiction and thereby replace the U.S. parent corporation of a multinational corporate group with a foreign parent corporation. These transactions are commonly referred to as inversion transactions. Inversion transactions may take many different forms, including stock inversions, asset inversions, and various combinations of and variations on the two. Most of the known transactions to date have been stock inversions. In one example of a stock inversion, a U.S. corporation forms a foreign corporation, which in turn forms a domestic merger subsidiary. The domestic merger subsidiary then merges into the U.S. corporation, with the U.S. corporation surviving, now as a subsidiary of the new foreign corporation. The U.S. corporation's shareholders receive shares of the foreign corporation and are treated as having exchanged their U.S. corporation shares for the foreign corporation shares. An asset inversion reaches a similar result, but through a direct merger of the top-tier U.S. corporation into a new foreign corporation, among other possible forms. An inversion transaction may be accompanied or followed by further restructuring of the corporate group. For example, in the case of a stock inversion, in order to remove income from foreign operations from the U.S. taxing jurisdiction, the U.S. corporation may transfer some or all of its foreign subsidiaries directly to the new foreign parent corporation or other related foreign corporations.

In addition to removing foreign operations from the U.S. taxing jurisdiction, the corporate group may derive further advantage from the inverted structure by reducing U.S. tax on U.S.-source income through various earnings stripping or other transactions. This may include earnings stripping through payment by a U.S. corporation of deductible amounts such as interest, royalties, rents, or management service fees to the new foreign parent or other foreign affiliates. In this respect, the post-inversion structure enables the group to employ the same tax-reduction strategies that are available to other multinational corporate groups with foreign parents and U.S. subsidiaries, subject to the same limitations (e.g., secs. 163(j) and 482).

Inversion transactions may give rise to immediate U.S. tax consequences at the shareholder and/or the corporate level, depending on the type of inversion. In stock inversions, the U.S. shareholders generally recognize gain (but not loss) under section 367(a), based on the difference between the fair market value of the foreign corporation shares received and the adjusted basis of the domestic corporation stock exchanged. To the extent that a corporation's share value has declined, and/or it has many foreign or tax-exempt share-

holders, the impact of this section 367(a) "toll charge" is reduced. The transfer of foreign subsidiaries or other assets to the foreign parent corporation also may give rise to U.S. tax consequences at the corporate level (e.g., gain recognition and earnings and profits inclusions under secs. 1001, 311(b), 304, 367, 1248 or other provisions). The tax on any income recognized as a result of these restructurings may be reduced or eliminated through the use of net operating losses, foreign tax credits, and other tax attributes.

In asset inversions, the U.S. corporation generally recognizes gain (but not loss) under section 367(a) as though it had sold all of its assets, but the shareholders generally do not recognize gain or loss, assuming the transaction meets the requirements of a reorganization under section 368.

### REASONS FOR CHANGE

The Committee believes that corporate inversion transactions are a symptom of larger problems with our current uncompetitive system for taxing U.S.-based global businesses and are also indicative of the unfair advantages that our tax laws convey to foreign ownership. The bill addresses the underlying problems with the U.S. system of taxing U.S.-based global businesses and contains provisions to remove the incentives for entering into inversion transactions. Imposing full U.S. tax on gains of companies undertaking an inversion transaction is one such provision that helps to remove the incentive to enter into an inversion transaction.

### EXPLANATION OF PROVISION

The bill applies special tax rules to corporations that undertake certain defined inversion transactions. For this purpose, an inversion is a transaction in which, pursuant to a plan or a series of related transactions: (1) a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity after March 4, 2003; (2) the former shareholders of the U.S. corporation hold (by reason of holding stock in the U.S. corporation) 60 percent or more (by vote or value) of the stock of the foreign-incorporated entity after the transaction; and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50-percent ownership (i.e., the "expanded affiliated group") does not conduct substantial business activities in the entity's country of incorporation compared to the total worldwide business activities of the expanded affiliated group.

In such a case, any applicable corporate-level "toll charges" for establishing the inverted structure are not offset by tax attributes such as net operating losses or foreign tax credits. Specifically, any applicable corporate-level income or gain required to be recognized under sections 304, 311(b), 367, 1001, 1248, or any other provision with respect to the transfer of controlled foreign corporation stock or the transfer or license of other assets by a U.S. corporation as part of the inversion transaction or after such transaction to a related foreign person is taxable, without offset by any tax attributes (e.g., net operating losses or foreign tax credits). This rule does not apply to certain transfers of inventory and similar property. These measures generally apply for a 10-year period following the inversion transaction.

In determining whether a transaction meets the definition of an inversion under the provision, stock held by members of the expanded affiliated group that includes the foreign incorporated entity is disregarded. For example, if the former top-tier U.S. corporation receives stock of the foreign incorporated entity (e.g., so-called "hook" stock), the stock would not be considered in determining whether the transaction meets the definition. Similarly, if a U.S. parent corporation converts an existing wholly owned U.S. subsidiary into a new wholly owned controlled foreign corporation, the stock of the new foreign corporation would be disregarded. Stock sold in a public offering related to the transaction also is disregarded for these purposes.

Transfers of properties or liabilities as part of a plan a principal purpose of which is to avoid the purposes of the provision are disregarded. In addition, the Treasury Secretary is granted authority to prevent the avoidance of the purposes of the provision, including avoidance through the use of related persons, pass-through or other noncorporate entities, or other intermediaries, and through transactions designed to qualify or disqualify a person as a related person or a member of an expanded affiliated group. Similarly, the Treasury Secretary is granted authority to treat certain non-stock instruments as stock, and certain stock as not stock, where necessary, to carry out the purposes of the provision.

Under the provision, inversion transactions include certain partnership transactions. Specifically, the provision applies to transactions in which a foreign-incorporated entity acquires substantially all of the properties constituting a trade or business of a domestic partnership, if after the acquisition at least 60 percent of the stock of the entity is held by former partners of the partnership (by reason of holding their partnership interests), provided that the other terms of the basic definition are met. For purposes of applying this test, all partnerships that are under common control within the meaning of section 482 are treated as one partnership, except as provided otherwise in regulations. In addition, the modified "toll charge" provisions apply at the partner level.

A transaction otherwise meeting the definition of an inversion transaction is not treated as an inversion transaction if, on or before March 4, 2003, the foreign-incorporated entity had acquired directly or indirectly more than half of the properties held directly or indirectly by the domestic corporation, or more than half of the properties constituting the partnership trade or business, as the case may be.

EFFECTIVE DATE

The provision applies to taxable years ending after March 4, 2003.

## 2. Excise tax on stock compensation of insiders in expatriated corporations (sec. 602 of the bill and secs. 162(m), 275(a), and new sec. 4985 of the Code)

### PRESENT LAW

The income taxation of a nonstatutory[204] compensatory stock option is determined under the rules that apply to property transferred in connection with the performance of services (sec. 83). If a nonstatutory stock option does not have a readily ascertainable fair market value at the time of grant, which is generally the case unless the option is actively traded on an established market, no amount is included in the gross income of the recipient with respect to the option until the recipient exercises the option.[205] Upon exercise of such an option, the excess of the fair market value of the stock purchased over the option price is generally included in the recipient's gross income as ordinary income in such taxable year.[206]

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

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

### REASONS FOR CHANGE

The Committee believes that certain inversion transactions are a means of avoiding U.S. tax and should be curtailed. The Committee is concerned that, while shareholders are generally required to recognize gain upon stock inversion transactions, executives holding stock options and certain stock-based compensation are not taxed upon such transactions. Since such executives are often instrumental in deciding whether to engage in inversion transactions, the Committee believes that, upon certain inversion transactions, it is appropriate to impose an excise tax on certain executives holding stock options and stock-based compensation. Because shareholders are taxed at the capital gains rate upon inversion transactions, the Committee believes that it is appropriate to impose the excise tax at an equivalent rate.

### EXPLANATION OF PROVISION

Under the provision, specified holders of stock options and other stock-based compensation are subject to an excise tax upon certain

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

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

[206] Under section 83, such amount is includable in gross income in the first taxable year in which the rights to the stock are transferable or are not subject to substantial risk of forfeiture.

inversion transactions. The provision imposes a 15-percent excise tax on the value of specified stock compensation held (directly or indirectly) by or for the benefit of a disqualified individual, or a member of such individual's family, at any time during the 12-month period beginning six months before the corporation's expatriation date. Specified stock compensation is treated as held for the benefit of a disqualified individual if such compensation is held by an entity, e.g., a partnership or trust, in which the individual, or a member of the individual's family, has an ownership interest.

A disqualified individual is any individual who, with respect to a corporation, is, at any time during the 12-month period beginning on the date which is six months before the expatriation date, subject to the requirements of section 16(a) of the Securities and Exchange Act of 1934 with respect to the corporation, or any member of the corporation's expanded affiliated group,[207] or would be subject to such requirements if the corporation (or member) were an issuer of equity securities referred to in section 16(a). Disqualified individuals generally include officers (as defined by section 16(a)),[208] directors, and 10-percent-or-greater owners of private and publicly-held corporations.

The excise tax is imposed on a disqualified individual of an expatriated corporation (as previously defined in the bill) only if gain (if any) is recognized in whole or part by any shareholder by reason of a corporate inversion transaction previously defined in the bill.

Specified stock compensation subject to the excise tax includes any payment[209] (or right to payment) granted by the expatriated corporation (or any member of the corporation's expanded affiliated group) to any person in connection with the performance of services by a disqualified individual for such corporation (or member of the corporation's expanded affiliated group) if the value of the payment or right is based on, or determined by reference to, the value or change in value of stock of such corporation (or any member of the corporation's expanded affiliated group). In determining whether such compensation exists and valuing such compensation, all restrictions, other than a non-lapse restriction, are ignored. Thus, the excise tax applies, and the value subject to the tax is determined, without regard to whether such specified stock compensation is subject to a substantial risk of forfeiture or is exercisable at the time of the inversion transaction. Specified stock compensation includes compensatory stock and restricted stock grants, compensatory stock options, and other forms of stock-based compensation, including stock appreciation rights, phantom stock, and phantom stock options. Specified stock compensation also includes nonqualified deferred compensation that is treated as though it were invested in stock or stock options of the expatriating corporation (or member). For example, the provision applies to a disqualified individual's deferred compensation if company stock is one of the ac-

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

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

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

tual or deemed investment options under the nonqualified deferred compensation plan.

Specified stock compensation includes a compensation arrangement that gives the disqualified individual an economic stake substantially similar to that of a corporate shareholder. Thus, the excise tax does not apply if a payment is simply triggered by a target value of the corporation's stock or where a payment depends on a performance measure other than the value of the corporation's stock. Similarly, the tax does not apply if the amount of the payment is not directly measured by the value of the stock or an increase in the value of the stock. For example, an arrangement under which a disqualified individual would be paid a cash bonus of $500,000 if the corporation's stock increased in value by 25 percent over two years or $1,000,000 if the stock increased by 33 percent over two years is not specified stock compensation, even though the amount of the bonus generally is keyed to an increase in the value of the stock. By contrast, an arrangement under which a disqualified individual would be paid a cash bonus equal to $10,000 for every $1 increase in the share price of the corporation's stock is subject to the provision because the direct connection between the compensation amount and the value of the corporation's stock gives the disqualified individual an economic stake substantially similar to that of a shareholder.

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

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

For specified stock compensation held on the expatriation date, the amount of the tax is determined based on the value of the compensation on such date. The tax imposed on specified stock compensation cancelled during the six-month period before the expatriation date is determined based on the value of the compensation on the day before such cancellation, while specified stock compensation granted after the expatriation date is valued on the date

granted. Under the provision, the cancellation of a non-lapse restriction is treated as a grant.

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

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

To the extent that a disqualified individual is also a covered employee under section 162(m), the $1,000,000 limit on the deduction allowed for employee remuneration for such employee is reduced by the amount of any payment (including reimbursements) made in

respect of the tax under the provision. As discussed above, this includes direct payments of the tax and payments to reimburse the individual for payment of the tax.

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

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

EFFECTIVE DATE

The provision is effective as of March 4, 2003, except that periods before March 4, 2003, are not taken into account in applying the excise tax to specified stock compensation held or cancelled during the six-month period before the expatriation date.

3. Reinsurance of U.S. risks in foreign jurisdictions (sec. 603 of the bill and sec. 845(a) of the Code)

PRESENT LAW

In the case of a reinsurance agreement between two or more related persons, present law provides the Treasury Secretary with authority to allocate among the parties or recharacterize income (whether investment income, premium or otherwise), deductions, assets, reserves, credits and any other items related to the reinsurance agreement, or make any other adjustment, in order to reflect the proper source and character of the items for each party.[210] For this purpose, related persons are defined as in section 482. Thus, persons are related if they are organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) that are owned or controlled directly or indirectly by the same interests. The provision may apply to a contract even if one of the related parties is not a domestic company.[211] In addition, the provision also permits such allocation, recharacterization, or other adjustments in a case in which one of the parties to a reinsurance agreement is, with respect to any contract covered by the agreement, in effect an agent of another party to the agreement, or a conduit between related persons.

REASONS FOR CHANGE

The Committee is concerned that reinsurance transactions are being used to allocate income, deductions, or other items inappropriately among U.S. and foreign related persons. The Committee is concerned that foreign related party reinsurance arrangements may be a technique for eroding the U.S. tax base. The Committee

[210] Sec. 845(a).

[211] See S. Rep. No. 97–494, 97th Cong., 2d Sess., 337 (1982) (describing provisions relating to the repeal of modified coinsurance provisions).

believes that the provision of present law permitting the Treasury Secretary to allocate or recharacterize items related to a reinsurance agreement should be applied to prevent misallocation, improper characterization, or to make any other adjustment in the case of such reinsurance transactions between U.S. and foreign related persons (or agents or conduits). The Committee also wishes to clarify that, in applying the authority with respect to reinsurance agreements, the amount, source or character of the items may be allocated, recharacterized or adjusted.

EXPLANATION OF PROVISION

The bill clarifies the rules of section 845, relating to authority for the Treasury Secretary to allocate items among the parties to a reinsurance agreement, recharacterize items, or make any other adjustment, in order to reflect the proper source and character of the items for each party. The bill authorizes such allocation, recharacterization, or other adjustment, in order to reflect the proper source, character or amount of the item. It is intended that this authority[212] be exercised in a manner similar to the authority under section 482 for the Treasury Secretary to make adjustments between related parties. It is intended that this authority be applied in situations in which the related persons (or agents or conduits) are engaged in cross-border transactions that require allocation, recharacterization, or other adjustments in order to reflect the proper source, character or amount of the item or items. No inference is intended that present law does not provide this authority with respect to reinsurance agreements.

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

EFFECTIVE DATE

The provision is effective for any risk reinsured after the date of enactment of the provision.

4. Revision of tax rules on expatriation of individuals (sec. 604 of the bill and secs. 877, 2107, 2501 and 6039G of the Code)

PRESENT LAW

*In general*

U.S. citizens and residents generally are subject to U.S income taxation on their worldwide income. The U.S. tax may be reduced or offset by a credit allowed for foreign income taxes paid with respect to foreign source income. Nonresident aliens are taxed at a flat rate of 30 percent (or a lower treaty rate) on certain types of passive income derived from U.S. sources, and at regular graduated rates on net profits derived from a U.S. trade or business. The estates of nonresident aliens generally are subject to estate tax on

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

U.S.-situated property (e.g., real estate and tangible property located within the United States and stock in a U.S. corporation). Nonresident aliens generally are subject to gift tax on transfers by gift of U.S.-situated property (e.g., real estate and tangible property located within the United States, but excluding intangibles, such as stock, regardless of where they are located).

*Income tax rules with respect to expatriates*

For the 10 taxable years after an individual relinquishes his or her U.S. citizenship or terminates his or her U.S. residency[213] with a principal purpose of avoiding U.S. taxes, the individual is subject to an alternative method of income taxation than that generally applicable to nonresident aliens (the "alternative tax regime"). Generally, the individual is subject to income tax only on U.S.-source income[214] at the rates applicable to U.S. citizens for the 10-year period.

An individual who relinquishes citizenship or terminates residency is treated as having done so with a principal purpose of tax avoidance and is generally subject to the alternative tax regime if: (1) the individual's average annual U.S. Federal income tax liability for the five taxable years preceding citizenship relinquishment or residency termination exceeds $100,000; or (2) the individual's net worth on the date of citizenship relinquishment or residency termination equals or exceeds $500,000. These amounts are adjusted annually for inflation.[215] Certain categories of individuals (e.g., dual residents) may avoid being deemed to have a tax avoidance purpose for relinquishing citizenship or terminating residency by submitting a ruling request to the IRS regarding whether the individual relinquished citizenship or terminated residency principally for tax reasons.

Anti-abuse rules are provided to prevent the circumvention of the alternative tax regime.

*Estate tax rules with respect to expatriates*

Special estate tax rules apply to individuals who relinquish their citizenship or long-term residency within the 10 years prior to the date of death, unless he or she did not have a tax avoidance purpose (as determined under the test above). Under these special rules, certain closely-held foreign stock owned by the former citizen or former long-term resident is includible in his or her gross estate to the extent that the foreign corporation owns U.S.-situated assets.

*Gift tax rules with respect to expatriates*

Special gift tax rules apply to individuals who relinquish their citizenship or long-term residency within the 10 years prior to the date of death, unless he or she did not have a tax avoidance purpose (as determined under the rules above). The individual is sub-

[213] Under present law, an individual's U.S. residency is considered terminated for U.S. Federal tax purposes when the individual ceases to be a lawful permanent resident under the immigration law (or is treated as a resident of another country under a tax treaty and does not waive the benefits of such treaty).

[214] For this purpose, however, U.S.-source income has a broader scope than it does typically in the Code.

[215] The income tax liability and net worth thresholds under section 877(a)(2) for 2004 are $124,000 and $622,000, respectively. See Rev. Proc. 2003–85, 2003–49 I.R.B. 1184.

ject to gift tax on gifts of U.S.-situated intangibles made during the 10 years following citizenship relinquishment or residency termination.

*Information reporting*

Under present law, U.S. citizens who relinquish citizenship and long-term residents who terminate residency generally are required to provide information about their assets held at the time of expatriation. However, this information is only required once.

REASONS FOR CHANGE

The Committee believes there are several difficulties in administering the present-law alternative tax regime. One such difficulty is that the IRS is required to determine the subjective intent of taxpayers who relinquish citizenship or terminate residency. The present-law presumption of a tax-avoidance purpose in cases in which objective income tax liability or net worth thresholds are exceeded mitigates this problem to some extent. However, the present-law rules still require the IRS to make subjective determinations of intent in cases involving taxpayers who fall below these thresholds, as well for certain taxpayers who exceed these thresholds but are nevertheless allowed to seek a ruling from the IRS to the effect that they did not have a principal purpose of tax avoidance. The Committee believes that the replacement of the subjective determination of tax avoidance as a principal purpose for citizenship relinquishment or residency termination with objective rules will result in easier administration of the tax regime for individuals who relinquish their citizenship or terminate residency.

Similarly, present-law information-reporting and return-filing provisions do not provide the IRS with the information necessary to administer the alternative tax regime. Although individuals are required to file tax information statements upon the relinquishment of their citizenship or termination of their residency, difficulties have been encountered in enforcing this requirement. The Committee believes that the tax benefits of citizenship relinquishment or residency termination should be denied an individual until he or she provides the information necessary for the IRS to enforce the alternative tax regime. The Committee also believes an annual report requirement and a penalty for the failure to comply with such requirement are needed to provide the IRS with sufficient information to monitor the compliance of former U.S. citizens and long-term residents.

Individuals who relinquish citizenship or terminate residency for tax reasons often do not want to fully sever their ties with the United States; they hope to retain some of the benefits of citizenship or residency without being subject to the U.S. tax system as a U.S. citizen or resident. These individuals generally may continue to spend significant amounts of time in the United States following citizenship relinquishment or residency termination—approximately four months every year—without being treated as a U.S. resident. The Committee believes that provisions in the bill that impose full U.S. taxation if the individual is present in the United States for more than 30 days in a calendar year will substantially reduce the incentives to relinquish citizenship or terminate resi-

dency for individuals who desire to maintain significant ties to the United States.

With respect to the estate and gift tax rules, the Committee is concerned that present-law does not adequately address opportunities for the avoidance of tax on the value of assets held by a foreign corporation whose stock the individual transfers. Thus, the provision imposes gift tax under the alternative tax regime in the case of gifts of certain stock of a closely held foreign corporation.

EXPLANATION OF PROVISION

*In general*

The bill provides: (1) objective standards for determining whether former citizens or former long-term residents are subject to the alternative tax regime; (2) tax-based (instead of immigration-based) rules for determining when an individual is no longer a U.S. citizen or long-term resident for U.S. Federal tax purposes; (3) the imposition of full U.S. taxation for individuals who are subject to the alternative tax regime and who return to the United States for extended periods; (4) imposition of U.S. gift tax on gifts of stock of certain closely-held foreign corporations that hold U.S.-situated property; and (5) an annual return-filing requirement for individuals who are subject to the alternative tax regime, for each of the 10 years following citizenship relinquishment or residency termination.[216]

*Objective rules for the alternative tax regime*

The bill replaces the subjective determination of tax avoidance as a principal purpose for citizenship relinquishment or residency termination under present law with objective rules. Under the bill, a former citizen or former long-term resident would be subject to the alternative tax regime for a 10-year period following citizenship relinquishment or residency termination, unless the former citizen or former long-term resident: (1) establishes that his or her average annual net income tax liability for the five preceding years does not exceed $124,000 (adjusted for inflation after 2004) and his or her net worth does not exceed $2 million, or alternatively satisfies limited, objective exceptions for dual citizens and minors who have had no substantial contact with the United States; and (2) certifies under penalties of perjury that he or she has complied with all U.S. Federal tax obligations for the preceding five years and provides such evidence of compliance as the Secretary of the Treasury may require.

The monetary thresholds under the bill replace the present-law inquiry into the taxpayer's intent. In addition, the bill eliminates the present-law process of IRS ruling requests.

If a former citizen exceeds the monetary thresholds, that person is excluded from the alternative tax regime if he or she falls within the exceptions for certain dual citizens and minors (provided that the requirement of certification and proof of compliance with Federal tax obligations is met). These exceptions provide relief to individuals who have never had substantial connections with the

[216] These provisions reflect recommendations contained in Joint Committee on Taxation, Review of the Present Law Tax and Immigration Treatment of Relinquishment of Citizenship and Termination of Long-Term Residency, (JCS–2–03), February 2003.

United States, as measured by certain objective criteria, and eliminate IRS inquiries as to the subjective intent of such taxpayers.

In order to be excepted from the application of the alternative tax regime under the bill, whether by reason of falling below the net worth and income tax liability thresholds or qualifying for the dual-citizen or minor exceptions, the former citizen or former long-term resident also is required to certify, under penalties of perjury, that he or she has complied with all U.S. Federal tax obligations for the five years preceding the relinquishment of citizenship or termination of residency and to provide such documentation as the Secretary of the Treasury may require evidencing such compliance (*e.g.,* tax returns, proof of tax payments). Until such time, the individual remains subject to the alternative tax regime. It is intended that the IRS will continue to verify that the information submitted was accurate, and it is intended that the IRS will randomly audit such persons to assess compliance.

*Termination of U.S. citizenship or long-term resident status for U.S. Federal income tax purposes*

Under the bill, an individual continues to be treated as a U.S. citizen or long-term resident for U.S. Federal tax purposes, including for purposes of section 7701(b)(10), until the individual: (1) gives notice of an expatriating act or termination of residency (with the requisite intent to relinquish citizenship or terminate residency) to the Secretary of State or the Secretary of Homeland Security, respectively; and (2) provides a statement in accordance with section 6039G.

*Sanction for individuals subject to the individual tax regime who return to the United States for extended periods*

The alternative tax regime does not apply to any individual for any taxable year during the 10-year period following citizenship relinquishment or residency termination if such individual is present in the United States for more than 30 days in the calendar year ending in such taxable year. Such individual is treated as a U.S. citizen or resident for such taxable year and therefore is taxed on his or her worldwide income.

Similarly, if an individual subject to the alternative tax regime is present in the United States for more than 30 days in any calendar year ending during the 10-year period following citizenship relinquishment or residency termination, and the individual dies during that year, he or she is treated as a U.S. resident, and the individual's worldwide estate is subject to U.S. estate tax. Likewise, if an individual subject to the alternative tax regime is present in the United States for more than 30 days in any year during the 10-year period following citizenship relinquishment or residency termination, the individual is subject to U.S. gift tax on any transfer of his or her worldwide assets by gift during that taxable year.

For purposes of these rules, an individual is treated as present in the United States on any day if such individual is physically present in the United States at any time during that day. The present-law exceptions from being treated as present in the United

States for residency purposes[217] generally do not apply for this purpose. However, for individuals with certain ties to countries other than the United States[218] and individuals with minimal prior physical presence in the United States,[219] a day of physical presence in the United States is disregarded if the individual is performing services in the United States on such day for an unrelated employer (within the meaning of sections 267 and 707(b)), who meets the requirements the Secretary of the Treasury may prescribe in regulations. No more than 30 days may be disregarded during any calendar year under this rule.

*Imposition of gift tax with respect to stock of certain closely held foreign corporations*

Gifts of stock of certain closely-held foreign corporations by a former citizen or former long-term resident who is subject to the alternative tax regime are subject to gift tax under this bill, if the gift is made within the 10-year period after citizenship relinquishment or residency termination. The gift tax rule applies if: (1) the former citizen or former long-term resident, before making the gift, directly or indirectly owns 10 percent or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation; and (2) directly or indirectly, is considered to own more than 50 percent of (a) the total combined voting power of all classes of stock entitled to vote in the foreign corporation, or (b) the total value of the stock of such corporation. If this stock ownership test is met, then taxable gifts of the former citizen or former long-term resident include that proportion of the fair market value of the foreign stock transferred by the individual, at the time of the gift, which the fair market value of any assets owned by such foreign corporation and situated in the United States (at the time of the gift) bears to the total fair market value of all assets owned by such foreign corporation (at the time of the gift).

This gift tax rule applies to a former citizen or former long-term resident who is subject to the alternative tax regime and who owns stock in a foreign corporation at the time of the gift, regardless of how such stock was acquired (e.g., whether issued originally to the donor, purchased, or received as a gift or bequest).

*Annual return*

The bill requires former citizens and former long-term residents to file an annual return for each year following citizenship relinquishment or residency termination in which they are subject to the alternative tax regime. The annual return is required even if no U.S. Federal income tax is due. The annual return requires certain information, including information on the permanent home of

[217] Secs. 7701(b)(3)(D), 7701(b)(5) and 7701(b)(7)(B)–(D).

[218] An individual has such a relationship to a foreign country if the individual becomes a citizen or resident of the country in which (1) the individual becomes fully liable for income tax or (2) the individual was born, such individual's spouse was born, or either of the individual's parents was born.

[219] An individual has a minimal prior physical presence in the United States if the individual was physically present for no more than 30 days during each year in the ten-year period ending on the date of loss of United States citizenship or termination of residency. However, an individual is not treated as being present in the United States on a day if (1) the individual is a teacher or trainee, a student, a professional athlete in certain circumstances, or a foreign government-related individual or (2) the individual remained in the United States because of a medical condition that arose while the individual was in the United States. Sec. 7701(b)(3)(D)(ii).

the individual, the individual's country of residence, the number of days the individual was present in the United States for the year, and detailed information about the individual's income and assets that are subject to the alternative tax regime. This requirement includes information relating to foreign stock potentially subject to the special estate tax rule of section 2107(b) and the gift tax rules of this bill.

If the individual fails to file the statement in a timely manner or fails correctly to include all the required information, the individual is required to pay a penalty of $5,000. The $5,000 penalty does not apply if it is shown that the failure is due to reasonable cause and not to willful neglect.

EFFECTIVE DATE

The provision applies to individuals who relinquish citizenship or terminate long-term residency after June 3, 2004.

5. Reporting of taxable mergers and acquisitions (sec. 605 of the bill and new sec. 6043A of the Code)

PRESENT LAW

Under section 6045 and the regulations thereunder, brokers (defined to include stock transfer agents) are required to make information returns and to provide corresponding payee statements as to sales made on behalf of their customers, subject to the penalty provisions of sections 6721–6724. Under the regulations issued under section 6045, this requirement generally does not apply with respect to taxable transactions other than exchanges for cash (e.g., stock inversion transactions taxable to shareholders by reason of section 367(a)).[220]

REASONS FOR CHANGE

The Committee believes that administration of the tax laws would be improved by greater information reporting with respect to taxable non-cash transactions, and that the Treasury Secretary's authority to require such enhanced reporting should be made explicit in the Code.

EXPLANATION OF PROVISION

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

(1) A description of the transaction;

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

[220] Recently issued temporary regulations under section 6043 (relating to information reporting with respect to liquidations, recapitalizations, and changes in control) impose information reporting requirements with respect to certain taxable inversion transactions, and proposed regulations would expand these requirements more generally to taxable transactions occurring after the proposed regulations are finalized.

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

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

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

In addition, every person required to make a return described above is required to furnish to each shareholder (or the shareholder's nominee[221]) whose name is required to be set forth in such return a written statement showing:

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

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

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

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

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

EFFECTIVE DATE

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

6. Studies (sec. 606 of the bill)

PRESENT LAW

Due to the variation in tax rates and tax systems among countries, a multinational enterprise, whether U.S.-based or foreign-based, may have an incentive to shift income, deductions, or tax credits in order to arrive at a reduced overall tax burden. Such a shifting of items could be accomplished by establishing artificial, non-arm's-length prices for transactions between group members.

Under section 482, the Treasury Secretary is authorized to reallocate income, deductions, or credits between or among two or more organizations, trades, or businesses under common control if he determines that such a reallocation is necessary to prevent tax evasion or to clearly reflect income. Treasury regulations adopt the arm's-length standard as the standard for determining whether such reallocations are appropriate. Thus, the regulations provide rules to identify the respective amounts of taxable income of the related parties that would have resulted if the parties had been uncontrolled parties dealing at arm's length. Transactions involving intangible property and certain services may present particular challenges to the administration of the arm's-length standard, because the nature of these transactions may make it difficult or impossible to compare them with third-party transactions.

In addition to the statutory rules governing the taxation of foreign income of U.S. persons and U.S. income of foreign persons, bi-

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

lateral income tax treaties limit the amount of income tax that may be imposed by one treaty partner on residents of the other treaty partner. For example, treaties often reduce or eliminate withholding taxes imposed by a treaty country on certain types of income (e.g., dividends, interest and royalties) paid to residents of the other treaty country. Treaties also contain provisions governing the creditability of taxes imposed by the treaty country in which income was earned in computing the amount of tax owed to the other country by its residents with respect to such income. Treaties further provide procedures under which inconsistent positions taken by the treaty countries with respect to a single item of income or deduction may be mutually resolved by the two countries.

### REASONS FOR CHANGE

The Committee believes that it is important to evaluate the effectiveness of the current transfer pricing rules and compliance efforts with respect to related-party transactions to ensure that income is not being shifted outside of the United States. The Committee also believes that it is necessary to review current U.S. income tax treaties to identify any inappropriate reductions in withholding tax rates that may create opportunities for shifting income outside the United States. In addition, the Committee believes that the impact of the provisions of this bill on inversion transactions should be studied.

### EXPLANATION OF PROVISION

The bill requires the Treasury Secretary to conduct and submit to the Congress three studies. The first study will examine the effectiveness of the transfer pricing rules of section 482, with an emphasis on transactions involving intangible property. The second study will examine income tax treaties to which the United States is a party, with a view toward identifying any inappropriate reductions in withholding tax or opportunities for abuse that may exist. The third study will examine the impact of the provisions of this bill on inversion transactions.

### EFFECTIVE DATE

The tax treaty study required under the provision is due no later than June 30, 2005. The transfer pricing study required under the provision is due no later than June 30, 2005. The inversions study required under the provision is due no later than December 31, 2005.

## B. Provisions Relating to Tax Shelters

### 1. Penalty for failure to disclose reportable transactions (sec. 611 of the bill and new sec. 6707A of the Code)

PRESENT LAW

Regulations under section 6011 require a taxpayer to disclose with its tax return certain information with respect to each "reportable transaction" in which the taxpayer participates.[222]

There are six categories of reportable transactions. The first category is any transaction that is the same as (or substantially similar to)[223] a transaction that is specified by the Treasury Department as a tax avoidance transaction whose tax benefits are subject to disallowance under present law (referred to as a "listed transaction").[224]

The second category is any transaction that is offered under conditions of confidentiality. In general, a transaction is considered to be offered to a taxpayer under conditions of confidentiality if the advisor who is paid a minimum fee places a limitation on disclosure by the taxpayer of the tax treatment or tax structure of the transaction and the limitation on disclosure protects the confidentiality of that advisor's tax strategies (irrespective if such terms are legally binding).[225]

The third category of reportable transactions is any transaction for which (1) the taxpayer has the right to a full or partial refund of fees if the intended tax consequences from the transaction are not sustained or, (2) the fees are contingent on the intended tax consequences from the transaction being sustained.[226]

The fourth category of reportable transactions relates to any transaction resulting in a taxpayer claiming a loss (under section 165) of at least (1) $10 million in any single year or $20 million in any combination of years by a corporate taxpayer or a partnership with only corporate partners; (2) $2 million in any single year or $4 million in any combination of years by all other partnerships, S corporations, trusts, and individuals; or (3) $50,000 in any single year for individuals or trusts if the loss arises with respect to foreign currency translation losses.[227]

The fifth category of reportable transactions refers to any transaction done by certain taxpayers[228] in which the tax treatment of the transaction differs (or is expected to differ) by more than $10

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

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

[223] The regulations clarify that the term "substantially similar" includes any transaction that is expected to obtain the same or similar types of tax consequences and that is either factually similar or based on the same or similar tax strategy. Further, the term must be broadly construed in favor of disclosure. Treas. Reg. sec. 1.6011–4(c)(4).

[224] Treas. Reg. sec. 1.6011–4(b)(2).

[225] Treas. Reg. sec. 1.6011–4(b)(3).

[226] Treas. Reg. sec. 1.6011–4(b)(4).

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

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

million from its treatment for book purposes (using generally accepted accounting principles) in any year.[229]

The final category of reportable transactions is any transaction that results in a tax credit exceeding $250,000 (including a foreign tax credit) if the taxpayer holds the underlying asset for less than 45 days.[230]

Under present law, there is no specific penalty for failing to disclose a reportable transaction; however, such a failure can jeopardize a taxpayer's ability to claim that any income tax understatement attributable to such undisclosed transaction is due to reasonable cause, and that the taxpayer acted in good faith.[231]

## REASONS FOR CHANGE

The Committee believes that the best way to combat tax shelters is to be aware of them. The Treasury Department, using the tools available, issued regulations requiring disclosure of certain transactions and requiring organizers and promoters of tax-engineered transactions to maintain customer lists and make these lists available to the IRS. Nevertheless, the Committee believes that additional legislation is needed to provide the Treasury Department with additional tools to assist its efforts to curtail abusive transactions. Moreover, the Committee believes that a penalty for failing to make the required disclosures, when the imposition of such penalty is not dependent on the tax treatment of the underlying transaction ultimately being sustained, will provide an additional incentive for taxpayers to satisfy their reporting obligations under the new disclosure provisions.

## EXPLANATION OF PROVISION

### *In general*

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

### *Transactions to be disclosed*

The provision does not define the terms "listed transaction"[232] or "reportable transaction," nor does the provision explain the type of information that must be disclosed in order to avoid the imposition of a penalty. Rather, the provision authorizes the Treasury Depart-

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

[230] Treas. Reg. sec. 1.6011–4(b)(7).

[231] Section 6664(c) provides that a taxpayer can avoid the imposition of a section 6662 accuracy-related penalty in cases where the taxpayer can demonstrate that there was reasonable cause for the underpayment and that the taxpayer acted in good faith. Regulations under sections 6662 and 6664 provide that a taxpayer's failure to disclose a reportable transaction is a strong indication that the taxpayer failed to act in good faith, which would bar relief under section 6664(c).

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

ment to define a "listed transaction" and a "reportable transaction" under section 6011.

*Penalty rate*

The penalty for failing to disclose a reportable transaction is $10,000 in the case of a natural person and $50,000 in any other case. The amount is increased to $100,000 and $200,000, respectively, if the failure is with respect to a listed transaction. The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the penalty can be rescinded (or abated) only if rescinding the penalty would promote compliance with the tax laws and effective tax administration. The authority to rescind the penalty can only be exercised by the IRS Commissioner personally. Thus, a revenue agent, an Appeals officer, or any other IRS personnel cannot rescind the penalty. The decision to rescind a penalty must be accompanied by a record describing the facts and reasons for the action and the amount rescinded. There will be no taxpayer right to appeal a refusal to rescind a penalty.[233] The IRS also is required to submit an annual report to Congress summarizing the application of the disclosure penalties and providing a description of each penalty rescinded under this provision and the reasons for the rescission.

EFFECTIVE DATE

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

2. Modifications to the accuracy-related penalties for listed transactions and reportable transactions having a significant tax avoidance purpose (sec. 612 of the bill and new sec. 6662A of the Code)

PRESENT LAW

The accuracy-related penalty applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of corporations), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.[234] The amount of any understatement generally is reduced by any portion attributable to an item if (1) the treatment of the item is or was supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.[235]

[233] This does not limit the ability of a taxpayer to challenge whether a penalty is appropriate (e.g., a taxpayer may litigate the issue of whether a transaction is a reportable transaction (and thus subject to the penalty if not disclosed) or not a reportable transaction (and thus not subject to the penalty)).

[234] Sec. 6662.

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

Special rules apply with respect to tax shelters.[236] For understatements by non-corporate taxpayers attributable to tax shelters, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for the position, the taxpayer reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters.

The understatement penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was "reasonable cause" for the underpayment and that the taxpayer acted in good faith.[237] The relevant regulations provide that reasonable cause exists where the taxpayer "reasonably relies in good faith on an opinion based on a professional tax advisor's analysis of the pertinent facts and authorities [that] * * * unambiguously concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged" by the IRS.[238]

REASONS FOR CHANGE

Because disclosure is so vital to combating abusive tax avoidance transactions, the Committee believes that taxpayers should be subject to a strict liability penalty on an understatement of tax that is attributable to non-disclosed listed transactions or non-disclosed reportable transactions that have a significant purpose of tax avoidance. Furthermore, in order to deter taxpayers from entering into tax avoidance transactions, the Committee believes that a more meaningful (but not a strict liability) accuracy-related penalty should apply to such transactions even when disclosed.

EXPLANATION OF PROVISION

*In general*

The provision modifies the present-law accuracy-related penalty by replacing the rules applicable to tax shelters with a new accuracy-related penalty that applies to listed transactions and reportable transactions with a significant tax avoidance purpose (hereinafter referred to as a "reportable avoidance transaction").[239] The penalty rate and defenses available to avoid the penalty vary depending on whether the transaction was adequately disclosed.

*Disclosed transactions*

In general, a 20-percent accuracy-related penalty is imposed on any understatement attributable to an adequately disclosed listed transaction or reportable avoidance transaction. The only exception to the penalty is if the taxpayer satisfies a more stringent reasonable cause and good faith exception (hereinafter referred to as the "strengthened reasonable cause exception"), which is described below. The strengthened reasonable cause exception is available only if the relevant facts affecting the tax treatment are adequately disclosed, there is or was substantial authority for the claimed tax

[236] Sec. 6662(d)(2)(C).
[237] Sec. 6664(c).
[238] Treas. Reg. sec. 1.6662–4(g)(4)(i)(B); Treas. Reg. sec. 1.6664–4(c).
[239] The terms "reportable transaction" and "listed transaction" have the same meanings as used for purposes of the penalty for failing to disclose reportable transactions.

treatment, and the taxpayer reasonably believed that the claimed tax treatment was more likely than not the proper treatment.

*Undisclosed transactions*

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

*Determination of the understatement amount*

The penalty is applied to the amount of any understatement attributable to the listed or reportable avoidance transaction without regard to other items on the tax return. For purposes of this provision, the amount of the understatement is determined as the sum of (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return),[240] and (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item.

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

*Strengthened reasonable cause exception*

A penalty is not imposed under the provision with respect to any portion of an understatement if it shown that there was reasonable cause for such portion and the taxpayer acted in good faith. Such a showing requires (1) adequate disclosure of the facts affecting the transaction in accordance with the regulations under section 6011,[241] (2) that there is or was substantial authority for such treatment, and (3) that the taxpayer reasonably believed that such treatment was more likely than not the proper treatment. For this purpose, a taxpayer will be treated as having a reasonable belief with respect to the tax treatment of an item only if such belief (1) is based on the facts and law that exist at the time the tax return (that includes the item) is filed, and (2) relates solely to the taxpayer's chances of success on the merits and does not take into account the possibility that (a) a return will not be audited, (b) the treatment will not be raised on audit, or (c) the treatment will be resolved through settlement if raised.

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

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

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

vided by a "disqualified tax advisor," or (2) is a "disqualified opinion."

*Disqualified tax advisor*

A disqualified tax advisor is any advisor who (1) is a material advisor[242] and who participates in the organization, management, promotion or sale of the transaction or is related (within the meaning of section 267(b) or 707(b)(1)) to any person who so participates, (2) is compensated directly or indirectly[243] by a material advisor with respect to the transaction, (3) has a fee arrangement with respect to the transaction that is contingent on all or part of the intended tax benefits from the transaction being sustained, or (4) as determined under regulations prescribed by the Secretary, has a disqualifying financial interest with respect to the transaction.

*Organization, management, promotion or sale of a transaction*—A material advisor is considered as participating in the "organization" of a transaction if the advisor performs acts relating to the development of the transaction. This may include, for example, preparing documents (1) establishing a structure used in connection with the transaction (such as a partnership agreement), (2) describing the transaction (such as an offering memorandum or other statement describing the transaction), or (3) relating to the registration of the transaction with any federal, state or local government body.[244] Participation in the "management" of a transaction means involvement in the decision-making process regarding any business activity with respect to the transaction. Participation in the "promotion or sale" of a transaction means involvement in the marketing or solicitation of the transaction to others. Thus, an advisor who provides information about the transaction to a potential participant is involved in the promotion or sale of a transaction, as is any advisor who recommends the transaction to a potential participant.

*Disqualified opinion*

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

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

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

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

*Coordination with other penalties*

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

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

EFFECTIVE DATE

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

3. Tax shelter exception to confidentiality privileges relating to taxpayer communications (sec. 613 of the bill and sec. 7525 of the Code)

PRESENT LAW

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

REASONS FOR CHANGE

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

EXPLANATION OF PROVISION

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

EFFECTIVE DATE

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

### 4. Statute of limitations for unreported listed transactions (sec. 614 of the bill and sec. 6501 of the Code)

PRESENT LAW

In general, the Code requires that taxes be assessed within three years[245] after the date a return is filed.[246] If there has been a substantial omission of items of gross income that totals more than 25 percent of the amount of gross income shown on the return, the period during which an assessment must be made is extended to six years.[247] If an assessment is not made within the required time periods, the tax generally cannot be assessed or collected at any future time. Tax may be assessed at any time if the taxpayer files a false or fraudulent return with the intent to evade tax or if the taxpayer does not file a tax return at all.[248]

REASONS FOR CHANGE

The Committee has noted that some taxpayers and their advisors have been employing dilatory tactics and failing to cooperate with the IRS in an attempt to avoid liability because of the expiration of the statute of limitations. The Committee accordingly believes that it is appropriate to extend the statute of limitations for unreported listed transactions.

EXPLANATION OF PROVISION

The provision extends the statute of limitations with respect to a listed transaction if a taxpayer fails to include on any return or statement for any taxable year any information with respect to a listed transaction[249] which is required to be included (under section 6011) with such return or statement. The statute of limitations with respect to such a transaction will not expire before the date which is one year after the earlier of (1) the date on which the Secretary is furnished the information so required, or (2) the date that a material advisor (as defined in 6111) satisfies the list maintenance requirements (as defined by section 6112) with respect to a request by the Secretary. For example, if a taxpayer engaged in a transaction in 2005 that becomes a listed transaction in 2007 and the taxpayer fails to disclose such transaction in the manner required by Treasury regulations, then the transaction is subject to the extended statute of limitations.[250]

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[245] Sec. 6501(a).

[246] For this purpose, a return that is filed before the date on which it is due is considered to be filed on the required due date (sec. 6501(b)(1)).

[247] Sec. 6501(e).

[248] Sec. 6501(c).

[249] The term "listed transaction" has the same meaning as described in a previous provision regarding the penalty for failure to disclose reportable transactions.

[250] If the Treasury Department lists a transaction in a year subsequent to the year in which a taxpayer entered into such transaction and the taxpayer's tax return for the year the transaction was entered into is closed by the statute of limitations prior to the date the transaction became a listed transaction, this provision does not re-open the statute of limitations with respect to such transaction for such year. However, if the purported tax benefits of the transaction are recognized over multiple tax years, the provision's extension of the statute of limitations shall apply to such tax benefits in any subsequent tax year in which the statute of limitations had not closed prior to the date the transaction became a listed transaction.

EFFECTIVE DATE

The provision is effective for taxable years with respect to which the period for assessing a deficiency did not expire before the date of enactment.

5. Disclosure of reportable transactions by material advisors (sec. 615 of the bill and secs. 6111 and 6707 of the Code)

PRESENT LAW

*Registration of tax shelter arrangements*

An organizer of a tax shelter is required to register the shelter with the Secretary not later than the day on which the shelter is first offered for sale.[251] A "tax shelter" means any investment with respect to which the tax shelter ratio[252] for any investor as of the close of any of the first five years ending after the investment is offered for sale may be greater than two to one and which is: (1) required to be registered under Federal or State securities laws, (2) sold pursuant to an exemption from registration requiring the filing of a notice with a Federal or State securities agency, or (3) a substantial investment (greater than $250,000 and involving at least five investors).[253]

Other promoted arrangements are treated as tax shelters for purposes of the registration requirement if: (1) a significant purpose of the arrangement is the avoidance or evasion of Federal income tax by a corporate participant; (2) the arrangement is offered under conditions of confidentiality; and (3) the promoter may receive fees in excess of $100,000 in the aggregate.[254]

In general, a transaction has a "significant purpose of avoiding or evading Federal income tax" if the transaction: (1) is the same as or substantially similar to a "listed transaction,"[255] or (2) is structured to produce tax benefits that constitute an important part of the intended results of the arrangement and the promoter reasonably expects to present the arrangement to more than one taxpayer.[256] Certain exceptions are provided with respect to the second category of transactions.[257]

An arrangement is offered under conditions of confidentiality if: (1) an offeree has an understanding or agreement to limit the disclosure of the transaction or any significant tax features of the transaction; or (2) the promoter knows, or has reason to know, that the offeree's use or disclosure of information relating to the transaction is limited in any other manner.[258]

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[251] Sec. 6111(a).

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

[253] Sec. 6111(c).

[254] Sec. 6111(d).

[255] Treas. Reg. sec. 301.6111–2(b)(2).

[256] Treas. Reg. sec. 301.6111–2(b)(3).

[257] Treas. Reg. sec. 301.6111–2(b)(4).

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

*Failure to register tax shelter*

The penalty for failing to timely register a tax shelter (or for filing false or incomplete information with respect to the tax shelter registration) generally is the greater of one percent of the aggregate amount invested in the shelter or $500.[259] However, if the tax shelter involves an arrangement offered to a corporation under conditions of confidentiality, the penalty is the greater of $10,000 or 50 percent of the fees payable to any promoter with respect to offerings prior to the date of late registration. Intentional disregard of the requirement to register increases the penalty to 75 percent of the applicable fees.

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

REASONS FOR CHANGE

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

EXPLANATION OF PROVISION

*Disclosure of reportable transactions by material advisors*

The provision repeals the present law rules with respect to registration of tax shelters. Instead, the provision requires each material advisor with respect to any reportable transaction (including any listed transaction)[260] to timely file an information return with the Secretary (in such form and manner as the Secretary may prescribe). The return must be filed on such date as specified by the Secretary.

The information return will include (1) information identifying and describing the transaction, (2) information describing any potential tax benefits expected to result from the transaction, and (3) such other information as the Secretary may prescribe. It is expected that the Secretary may seek from the material advisor the same type of information that the Secretary may request from a taxpayer in connection with a reportable transaction.[261]

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

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[259] Sec. 6707.

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

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

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

*Penalty for failing to furnish information regarding reportable transactions*

The provision repeals the present-law penalty for failure to register tax shelters. Instead, the provision imposes a penalty on any material advisor who fails to file an information return, or who files a false or incomplete information return, with respect to a reportable transaction (including a listed transaction).[262] The amount of the penalty is $50,000. If the penalty is with respect to a listed transaction, the amount of the penalty is increased to the greater of (1) $200,000, or (2) 50 percent of the gross income of such person with respect to aid, assistance, or advice which is provided with respect to the transaction before the date the information return that includes the transaction is filed. Intentional disregard by a material advisor of the requirement to disclose a listed transaction increases the penalty to 75 percent of the gross income.

The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the penalty can be rescinded (or abated) only in exceptional circumstances.[263] All or part of the penalty may be rescinded only if rescinding the penalty would promote compliance with the tax laws and effective tax administration. The authority to rescind the penalty can only be exercised by the Commissioner personally. Thus, a revenue agent, an Appeals officer, or other IRS personnel cannot rescind the penalty. The decision to rescind a penalty must be accompanied by a record describing the facts and reasons for the action and the amount rescinded. There will be no right to appeal a refusal to rescind a penalty. The IRS also is required to submit an annual report to Congress summarizing the application of the disclosure penalties and providing a description of each penalty rescinded under this provision and the reasons for the rescission.

EFFECTIVE DATE

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

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

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

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

## 6. Investor lists and modification of penalty for failure to maintain investor lists (secs. 616 and 617 of the bill and secs. 6112 and 6708 of the Code)

### PRESENT LAW

*Investor lists*

Any organizer or seller of a potentially abusive tax shelter must maintain a list identifying each person who was sold an interest in any such tax shelter with respect to which registration was required under section 6111 (even though the particular party may not have been subject to confidentiality restrictions).[264] Recently issued regulations under section 6112 contain rules regarding the list maintenance requirements.[265] In general, the regulations apply to transactions that are potentially abusive tax shelters entered into, or acquired after, February 28, 2003.[266]

The regulations provide that a person is an organizer or seller of a potentially abusive tax shelter if the person is a material advisor with respect to that transaction.[267] A material advisor is defined as any person who is required to register the transaction under section 6111, or expects to receive a minimum fee of (1) $250,000 for a transaction that is a potentially abusive tax shelter if all participants are corporations, or (2) $50,000 for any other transaction that is a potentially abusive tax shelter.[268] For listed transactions (as defined in the regulations under section 6011), the minimum fees are reduced to $25,000 and $10,000, respectively.

A potentially abusive tax shelter is any transaction that (1) is required to be registered under section 6111, (2) is a listed transaction (as defined under the regulations under section 6011), or (3) any transaction that a potential material advisor, at the time the transaction is entered into, knows is or reasonably expects will become a reportable transaction (as defined under the new regulations under section 6011).[269]

The Secretary is required to prescribe regulations which provide that, in cases in which two or more persons are required to maintain the same list, only one person would be required to maintain the list.[270]

*Penalty for failing to maintain investor lists*

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

### REASONS FOR CHANGE

The Committee has been advised that the present-law penalties for failure to maintain customer lists are not meaningful and that promoters often have refused to provide requested information to the IRS. The Committee believes that requiring material advisors

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[264] Sec. 6112.

[265] Treas. Reg. sec. 301.6112–1.

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

[267] Treas. Reg. sec. 301.6112–1(c)(1).

[268] Treas. Reg. sec. 301.6112–1(c)(2) and (3).

[269] Treas. Reg. sec. 301.6112–1(b).

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

to maintain a list of advisees with respect to each reportable transaction, coupled with more meaningful penalties for failing to maintain an investor list, are important tools in the ongoing efforts to curb the use of abusive tax avoidance transactions.

EXPLANATION OF PROVISION

*Investor lists*

Each material advisor[271] with respect to a reportable transaction (including a listed transaction)[272] is required to maintain a list that (1) identifies each person with respect to whom the advisor acted as a material advisor with respect to the reportable transaction, and (2) contains other information as may be required by the Secretary. In addition, the provision authorizes (but does not require) the Secretary to prescribe regulations which provide that, in cases in which two or more persons are required to maintain the same list, only one person would be required to maintain the list.

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

*Penalty for failing to maintain investor lists*

The provision modifies the penalty for failing to maintain the required list by making it a time-sensitive penalty. Thus, a material advisor who is required to maintain an investor list and who fails to make the list available upon written request by the Secretary within 20 business days after the request will be subject to a $10,000 per day penalty. The penalty applies to a person who fails to maintain a list, maintains an incomplete list, or has in fact maintained a list but does not make the list available to the Secretary. The penalty can be waived if the failure to make the list available is due to reasonable cause.[273]

EFFECTIVE DATE

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

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

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

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

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

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

7. Penalty on promoters of tax shelters (sec. 618 of the bill and sec. 6700 of the Code)

PRESENT LAW

A penalty is imposed on any person who organizes, assists in the organization of, or participates in the sale of any interest in, a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if in connection with such activity the person makes or furnishes a qualifying false or fraudulent statement or a gross valuation overstatement.[274] A qualified false or fraudulent statement is any statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter. A "gross valuation overstatement" means any statement as to the value of any property or services if the stated value exceeds 200 percent of the correct valuation, and the value is directly related to the amount of any allowable income tax deduction or credit.

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

REASONS FOR CHANGE

The Committee believes that the present-law $1,000 penalty for tax shelter promoters is insufficient to deter tax shelter activities. The Committee believes that the increased penalties for tax shelter promoters are meaningful and will help deter the promotion of tax shelters.

EXPLANATION OF PROVISION

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

EFFECTIVE DATE

The provision is effective for activities after the date of enactment.

[274] Sec. 6700.

8. Modifications of substantial understatement penalty for non-reportable transactions (sec. 619 of the bill and sec. 6662 of the Code)

PRESENT LAW

An accuracy-related penalty equal to 20 percent applies to any substantial understatement of tax. A "substantial understatement" exists if the correct income tax liability for a taxable year exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of most corporations).[275]

REASONS FOR CHANGE

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

EXPLANATION OF PROVISION

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

EFFECTIVE DATE

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

9. Modification of actions to enjoin certain conduct related to tax shelters and reportable transactions (sec. 620 of the bill and sec. 7408 of the Code)

PRESENT LAW

The Code authorizes civil actions to enjoin any person from promoting abusive tax shelters or aiding or abetting the understatement of tax liability.[276]

REASONS FOR CHANGE

The Committee believes that expanding the authority to obtain injunctions against promoters and material advisors that (1) fail to file an information return with respect to a reportable transaction or (2) fail to maintain, or to timely furnish upon written request by the Secretary, a list of investors with respect to reportable transactions will discourage tax shelter activity and encourage compliance with the tax shelter disclosure requirements.

[275] Sec. 6662(a) and (d)(1)(A).
[276] Sec. 7408.

EXPLANATION OF PROVISION

The provision expands this rule so that injunctions may also be sought with respect to the requirements relating to the reporting of reportable transactions[277] and the keeping of lists of investors by material advisors.[278] Thus, under the provision, an injunction may be sought against a material advisor to enjoin the advisor from (1) failing to file an information return with respect to a reportable transaction, or (2) failing to maintain, or to timely furnish upon written request by the Secretary, a list of investors with respect to each reportable transaction.

EFFECTIVE DATE

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

10. Penalty on failure to report interests in foreign financial accounts (sec. 621 of the bill and sec. 5321 of Title 31, United States Code)

PRESENT LAW

The Secretary must require citizens, residents, or persons doing business in the United States to keep records and file reports when that person makes a transaction or maintains an account with a foreign financial entity.[279] In general, individuals must fulfill this requirement by answering questions regarding foreign accounts or foreign trusts that are contained in Part III of Schedule B of the IRS Form 1040. Taxpayers who answer "yes" in response to the question regarding foreign accounts must then file Treasury Department Form TD F 90–22.1. This form must be filed with the Department of the Treasury, and not as part of the tax return that is filed with the IRS.

The Secretary may impose a civil penalty on any person who willfully violates this reporting requirement. The civil penalty is the amount of the transaction or the value of the account, up to a maximum of $100,000; the minimum amount of the penalty is $25,000.[280] In addition, any person who willfully violates this reporting requirement is subject to a criminal penalty. The criminal penalty is a fine of not more than $250,000 or imprisonment for not more than five years (or both); if the violation is part of a pattern of illegal activity, the maximum amount of the fine is increased to $500,000 and the maximum length of imprisonment is increased to 10 years.[281]

On April 26, 2002, the Secretary submitted to the Congress a report on these reporting requirements.[282] This report, which was statutorily required,[283] studies methods for improving compliance with these reporting requirements. It makes several administrative recommendations, but no legislative recommendations. A further

[277] Sec. 6707, as amended by other provisions of this bill.
[278] Sec. 6708, as amended by other provisions of this bill.
[279] 31 U.S.C. sec. 5314.
[280] 31 U.S.C. sec. 5321(a)(5).
[281] 31 U.S.C. sec. 5322.
[282] A Report to Congress in Accordance with Sec. 361(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, April 26, 2002.
[283] Sec. 361(b) of the USA PATRIOT Act of 2001 (Pub. L. No. 107–56).

report was required to be submitted by the Secretary to the Congress by October 26, 2002.

REASONS FOR CHANGE

The Committee believes that imposing a new civil penalty for failure to report an interest in foreign financial accounts that applies (without regard to willfulness) will increase the reporting of foreign financial accounts.

EXPLANATION OF PROVISION

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

EFFECTIVE DATE

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

11. Regulation of individuals practicing before the Department of the Treasury (sec. 622 of the bill and sec. 330 of Title 31, United States Code)

PRESENT LAW

The Secretary is authorized to regulate the practice of representatives of persons before the Department of the Treasury.[284] The Secretary is also authorized to suspend or disbar from practice before the Department a representative who is incompetent, who is disreputable, who violates the rules regulating practice before the Department, or who (with intent to defraud) willfully and knowingly misleads or threatens the person being represented (or a person who may be represented). The rules promulgated by the Secretary pursuant to this provision are contained in Circular 230.

REASONS FOR CHANGE

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

EXPLANATION OF PROVISION

The provision makes two modifications to expand the sanctions that the Secretary may impose pursuant to these statutory provisions. First, the provision expressly permits censure as a sanction. Second, the provision permits the imposition of a monetary penalty as a sanction. If the representative is acting on behalf of an employer or other entity, the Secretary may impose a monetary penalty on the employer or other entity if it knew, or reasonably

[284] 31 U.S.C. sec. 330.

should have known, of the conduct. This monetary penalty on the employer or other entity may be imposed in addition to any monetary penalty imposed directly on the representative. These monetary penalties are not to exceed the gross income derived (or to be derived) from the conduct giving rise to the penalty. These monetary penalties may be in addition to, or in lieu of, any suspension, disbarment, or censure of such individual.

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

EFFECTIVE DATE

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

12. Treatment of stripped interests in bond and preferred stock funds, etc. (sec. 631 of the bill and secs. 305 and 1286 of the Code)

PRESENT LAW

*Assignment of income in general*

In general, an "income stripping" transaction involves a transaction in which the right to receive future income from income-producing property is separated from the property itself. In such transactions, it may be possible to generate artificial losses from the disposition of certain property or to defer the recognition of taxable income associated with such property.

Common law has developed a rule (referred to as the "assignment of income" doctrine) whereby income that is transferred without an accompanying transfer of the underlying property is not respected. A leading judicial decision relating to the assignment of income doctrine involved a case in which a taxpayer made a gift of detachable interest coupons before their due date while retaining the bearer bond. The U.S. Supreme Court ruled that the donor was taxable on the entire amount of interest when paid to the donee on the grounds that the transferor had "assigned" to the donee the right to receive the income.[285]

In addition to general common law assignment of income principles, specific statutory rules have been enacted to address certain specific types of stripping transactions, such as transactions involving stripped bonds and stripped preferred stock (which are discussed below).[286] However, there are no specific statutory rules

[285] *Helvering* v. *Horst,* 311 U.S. 112 (1940).

[286] Depending on the facts, the IRS also could determine that a variety of other Code-based and common law-based authorities could apply to income stripping transactions, including: (1) sections 165, 269, 382, 446(b), 482, 701, or 704 and the regulations thereunder; (2) authorities that recharacterize certain assignments or accelerations of future payments as financings; (3) business purpose, economic substance, and sham transaction doctrines; (4) the step transaction doctrine; and (5) the substance-over-form doctrine. See Notice 2003–55, 2003–34 I.R.B. 395, modifying and superseding Notice 95–53, 1995–2 C.B. 334 (accounting for lease strips and other stripping transactions).

that address stripping transactions with respect to common stock or other equity interests (other than preferred stock).[287]

*Stripped bonds*

Special rules are provided with respect to the purchaser and "stripper" of stripped bonds.[288] A "stripped bond" is defined as a debt instrument in which there has been a separation in ownership between the underlying debt instrument and any interest coupon that has not yet become payable.[289] In general, upon the disposition of either the stripped bond or the detached interest coupons each of the retained portion and the portion that is disposed is treated as a new bond that is purchased at a discount and is payable in a fixed amount on a future date. Accordingly, section 1286 treats both the stripped bond and the detached interest coupons as individual bonds that are newly issued with original issue discount ("OID") on the date of disposition. Consequently, section 1286 effectively subjects the stripped bond and the detached interest coupons to the general OID periodic income inclusion rules.

A taxpayer who purchases a stripped bond or one or more stripped coupons is treated as holding a new bond that is issued on the purchase date with OID in an amount that is equal to the excess of the stated redemption price at maturity (or in the case of a coupon, the amount payable on the due date) over the ratable share of the purchase price of the stripped bond or coupon, determined on the basis of the respective fair market values of the stripped bond and coupons on the purchase date.[290] The OID on the stripped bond or coupon is includible in gross income under the general OID periodic income inclusion rules.

A taxpayer who strips a bond and disposes of either the stripped bond or one or more stripped coupons must allocate his basis, immediately before the disposition, in the bond (with the coupons attached) between the retained and disposed items.[291] Special rules apply to require that interest or market discount accrued on the bond prior to such disposition must be included in the taxpayer's gross income (to the extent that it had not been previously included in income) at the time the stripping occurs, and the taxpayer increases his basis in the bond by the amount of such accrued interest or market discount. The adjusted basis (as increased by any accrued interest or market discount) is then allocated between the stripped bond and the stripped interest coupons in relation to their respective fair market values. Amounts realized from the sale of stripped coupons or bonds constitute income to the taxpayer only to the extent such amounts exceed the basis allocated to the stripped coupons or bond. With respect to retained items (either the detached coupons or stripped bond), to the extent that the price payable on maturity, or on the due date of the coupons, exceeds the portion of the taxpayer's basis allocable to such retained items, the

[287] However, in *Estate of Stranahan* v. *Commissioner,* 472 F.2d 867 (6th Cir. 1973), the court held that where a taxpayer sold a carved-out interest of stock dividends, with no personal obligation to produce the income, the transaction was treated as a sale of an income interest.

[288] Sec. 1286.

[289] Sec. 1286(e).

[290] Sec. 1286(a).

[291] Sec. 1286(b). Similar rules apply in the case of any person whose basis in any bond or coupon is determined by reference to the basis in the hands of a person who strips the bond.

difference is treated as OID that is required to be included under the general OID periodic income inclusion rules.[292]

*Stripped preferred stock*

"Stripped preferred stock" is defined as preferred stock in which there has been a separation in ownership between such stock and any dividend on such stock that has not become payable.[293] A taxpayer who purchases stripped preferred stock is required to include in gross income, as ordinary income, the amounts that would have been includible if the stripped preferred stock was a bond issued on the purchase date with OID equal to the excess of the redemption price of the stock over the purchase price.[294] This treatment is extended to any taxpayer whose basis in the stock is determined by reference to the basis in the hands of the purchaser. A taxpayer who strips and disposes the future dividends is treated as having purchased the stripped preferred stock on the date of such disposition for a purchase price equal to the taxpayer's adjusted basis in the stripped preferred stock.[295]

REASONS FOR CHANGE

The Committee is concerned that taxpayers are entering into tax avoidance transactions to generate artificial losses, or defer the recognition of ordinary income and convert such income into capital gains, by selling or purchasing stripped interests that are not subject to the present-law rules relating to stripped bonds and preferred stock but that represent interests in bonds or preferred stock. Therefore, the Committee believes that it is appropriate to provide Treasury with regulatory authority to apply such rules to interests that do not constitute bonds or preferred stock but nevertheless derive their economic value and characteristics exclusively from underlying bonds or preferred stock.

EXPLANATION OF PROVISION

The provision authorizes the Treasury Department to promulgate regulations that, in appropriate cases, apply rules that are similar to the present-law rules for stripped bonds and stripped preferred stock to direct or indirect interests in an entity or account substantially all of the assets of which consist of bonds (as defined in section 1286(e)(1)), preferred stock (as defined in section 305(e)(5)(B)), or any combination thereof. The provision applies only to cases in which the present-law rules for stripped bonds and stripped preferred stock do not already apply to such interests.

For example, such Treasury regulations could apply to a transaction in which a person effectively strips future dividends from shares in a money market mutual fund (and disposes either the stripped shares or stripped future dividends) by contributing the shares (with the future dividends) to a custodial account through which another person purchases rights to either the stripped shares or the stripped future dividends. However, it is intended

[292] Special rules are provided with respect to stripping transactions involving tax-exempt obligations that treat OID (computed under the stripping rules) in excess of OID computed on the basis of the bond's coupon rate (or higher rate if originally issued at a discount) as income from a non-tax-exempt debt instrument (sec. 1286(d)).

[293] Sec. 305(e)(5).

[294] Sec. 305(e)(1).

[295] Sec. 305(e)(3).

that Treasury regulations issued under this provision would not apply to certain transactions involving direct or indirect interests in an entity or account substantially all the assets of which consist of tax-exempt obligations (as defined in section 1275(a)(3)), such as an eligible tax-exempt bond partnership described in Rev. Proc. 2003–84,[296] modifying and superseding Rev. Proc. 2002–68[297] and Rev. Proc. 2002–16.[298]

No inference is intended as to the treatment under the present-law rules for stripped bonds and stripped preferred stock, or under any other provisions or doctrines of present law, of interests in an entity or account substantially all of the assets of which consist of bonds, preferred stock, or any combination thereof. The Treasury regulations, when issued, would be applied prospectively, except in cases to prevent abuse.

EFFECTIVE DATE

The provision is effective for purchases and dispositions occurring after the date of enactment.

13. Minimum holding period for foreign tax credit on withholding taxes on income other than dividends (sec. 632 of the bill and sec. 901 of the Code)

PRESENT LAW

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

As a consequence of the foreign tax credit limitations of the Code, certain taxpayers are unable to utilize their creditable foreign taxes to reduce their U.S. tax liability. U.S. taxpayers that are tax-exempt receive no U.S. tax benefit for foreign taxes paid on income that they receive.

Present law denies a U.S. shareholder the foreign tax credits normally available with respect to a dividend from a corporation or a regulated investment company ("RIC") if the shareholder has not held the stock for more than 15 days (within a 30-day testing period) in the case of common stock or more than 45 days (within a 90-day testing period) in the case of preferred stock (sec. 901(k)). The disallowance applies both to foreign tax credits for foreign withholding taxes that are paid on the dividend where the dividend-paying stock is held for less than these holding periods, and to indirect foreign tax credits for taxes paid by a lower-tier foreign corporation or a RIC where any of the required stock in the chain of ownership is held for less than these holding periods. Periods during which a taxpayer is protected from risk of loss (e.g., by purchasing a put option or entering into a short sale with respect to the stock) generally are not counted toward the holding period requirement. In the case of a bona fide contract to sell stock, a special rule applies for purposes of indirect foreign tax credits. The

[296] 2003–48 I.R.B. 1159.
[297] 2002–43 I.R.B. 753.
[298] 2002–9 I.R.B. 572.

disallowance does not apply to foreign tax credits with respect to certain dividends received by active dealers in securities. If a taxpayer is denied foreign tax credits because the applicable holding period is not satisfied, the taxpayer is entitled to a deduction for the foreign taxes for which the credit is disallowed.

REASONS FOR CHANGE

The Committee believes that the present-law holding period requirement for claiming foreign tax credits with respect to dividends is too narrow in scope and, in general, should be extended to apply to items of income or gain other than dividends, such as interest.

EXPLANATION OF PROVISION

The provision expands the present-law disallowance of foreign tax credits to include credits for gross-basis foreign withholding taxes with respect to any item of income or gain from property if the taxpayer who receives the income or gain has not held the property for more than 15 days (within a 30–day testing period), exclusive of periods during which the taxpayer is protected from risk of loss. The provision does not apply to foreign tax credits that are subject to the present-law disallowance with respect to dividends. The provision also does not apply to certain income or gain that is received with respect to property held by active dealers. Rules similar to the present-law disallowance for foreign tax credits with respect to dividends apply to foreign tax credits that are subject to the provision. In addition, the provision authorizes the Treasury Department to issue regulations providing that the provision does not apply in appropriate cases.

EFFECTIVE DATE

The provision is effective for amounts that are paid or accrued more than 30 days after the date of enactment.

14. Disallowance of certain partnership loss transfers (sec. 633 of the bill and secs. 704, 734, and 743 of the Code)

PRESENT LAW

*Contributions of property*

Under present law, if a partner contributes property to a partnership, generally no gain or loss is recognized to the contributing partner at the time of contribution.[299] The partnership takes the property at an adjusted basis equal to the contributing partner's adjusted basis in the property.[300] The contributing partner increases its basis in its partnership interest by the adjusted basis of the contributed property.[301] Any items of partnership income, gain, loss and deduction with respect to the contributed property are allocated among the partners to take into account any built-in gain or loss at the time of the contribution.[302] This rule is intended to prevent the transfer of built-in gain or loss from the contributing partner to the other partners by generally allocating items to the

[299] Sec. 721.
[300] Sec. 723.
[301] Sec. 722.
[302] Sec. 704(c)(1)(A).

noncontributing partners based on the value of their contributions and by allocating to the contributing partner the remainder of each item.[303]

If the contributing partner transfers its partnership interest, the built-in gain or loss will be allocated to the transferee partner as it would have been allocated to the contributing partner.[304] If the contributing partner's interest is liquidated, there is no specific guidance preventing the allocation of the built-in loss to the remaining partners. Thus, it appears that losses can be "transferred" to other partners where the contributing partner no longer remains a partner.

*Transfers of partnership interests*

Under present law, a partnership does not adjust the basis of partnership property following the transfer of a partnership interest unless the partnership has made a one-time election under section 754 to make basis adjustments.[305] If an election is in effect, adjustments are made with respect to the transferee partner to account for the difference between the transferee partner's proportionate share of the adjusted basis of the partnership property and the transferee's basis in its partnership interest.[306] These adjustments are intended to adjust the basis of partnership property to approximate the result of a direct purchase of the property by the transferee partner. Under these rules, if a partner purchases an interest in a partnership with an existing built-in loss and no election under section 754 is in effect, the transferee partner may be allocated a share of the loss when the partnership disposes of the property (or depreciates the property).

*Distributions of partnership property*

With certain exceptions, partners may receive distributions of partnership property without recognition of gain or loss by either the partner or the partnership.[307] In the case of a distribution in liquidation of a partner's interest, the basis of the property distributed in the liquidation is equal to the partner's adjusted basis in its partnership interest (reduced by any money distributed in the transaction).[308] In a distribution other than in liquidation of a partner's interest, the distributee partner's basis in the distributed property is equal to the partnership's adjusted basis in the property immediately before the distribution, but not to exceed the partner's adjusted basis in the partnership interest (reduced by any money distributed in the same transaction).[309]

Adjustments to the basis of the partnership's undistributed properties are not required unless the partnership has made the election under section 754 to make basis adjustments.[310] If an election is in effect under section 754, adjustments are made by a partnership to increase or decrease the remaining partnership assets to re-

[303] If there is an insufficient amount of an item to allocate to the noncontributing partners, Treasury regulations allow for curative or remedial allocations to remedy this insufficiency. Treas. Reg. sec. 1.704–3(c) and (d).
[304] Treas. Reg. 1.704–3(a)(7).
[305] Sec. 743(a).
[306] Sec. 743(b).
[307] Sec. 731(a) and (b).
[308] Sec. 732(b).
[309] Sec. 732(a).
[310] Sec. 734(a).

flect any increase or decrease in the adjusted basis of the distributed properties in the hands of the distributee partner (or gain or loss recognized by the distributee partner).[311] To the extent the adjusted basis of the distributed properties increases (or loss is recognized) the partnership's adjusted basis in its properties is decreased by a like amount; likewise, to the extent the adjusted basis of the distributed properties decrease (or gain is recognized), the partnership's adjusted basis in its properties is increased by a like amount. Under these rules, a partnership with no election in effect under section 754 may distribute property with an adjusted basis lower than the distributee partner's proportionate share of the adjusted basis of all partnership property and leave the remaining partners with a smaller net built-in gain or a larger net built-in loss than before the distribution.

REASONS FOR CHANGE

The Committee believes that the partnership rules currently allow for the inappropriate transfer of losses among partners. This has allowed partnerships to be created and used to aid tax-shelter transactions. The bill limits the ability to transfer losses among partners, while preserving the simplification aspects of the current partnership rules for transactions involving smaller amounts. The Committee was made aware that certain types of investment partnerships would incur administrative difficulties in making partnership-level basis adjustments in the event of a transfer of a partnership interest, as evidenced by the present practice of a number of investment partnerships not to elect partnership basis adjustments even when the adjustments would be upward adjustments to the basis of partnership property. Accordingly, the bill provides a partner-level loss limitation as an alternative to the partnership basis adjustments otherwise required under the bill in the case of transfers of interests in certain investment partnerships that are engaged in investment activities rather than in any trade or business activity.

EXPLANATION OF PROVISION

*Contributions of property*

Under the provision, a built-in loss may be taken into account only by the contributing partner and not by other partners. Except as provided in regulations, in determining the amount of items allocated to partners other than the contributing partner, the basis of the contributed property is treated as the fair market value at the time of contribution. Thus, if the contributing partner's partnership interest is transferred or liquidated, the partnership's adjusted basis in the property is based on its fair market value at the time of contribution, and the built-in loss is eliminated.[312]

*Transfers of partnership interests*

The provision provides generally that the basis adjustment rules under section 743 are mandatory in the case of the transfer of a partnership interest with respect to which there is a substantial

[311] Sec. 734(b).

[312] It is intended that a corporation succeeding to attributes of the contributing corporate partner under section 381 shall be treated in the same manner as the contributing partner.

built-in loss (rather than being elective as under present law). For this purpose, a substantial built-in loss exists if the partnership's adjusted basis in its property exceeds by more than $250,000 the fair market value of the partnership property.

Thus, for example, assume that partner A sells his 25-percent partnership interest to B for its fair market value of $1 million. Also assume that, immediately after the transfer, the fair market value of partnership assets is $4 million and the partnership's adjusted basis in the partnership assets is $4.3 million. Under the bill, section 743(b) applies, so that an adjustment is required to the adjusted basis of the partnership assets with respect to B. As a result, B would recognize no gain or loss if the partnership immediately sold all its assets for their fair market value.

The bill provides that an electing investment partnership is not treated as having a substantial built-in loss, and thus is not required to make basis adjustments to partnership property, in the case of a transfer of a partnership interest. In lieu of the partnership basis adjustments, a partner-level loss limitation rule applies. Under this rule, the transferee partner's distributive share of losses (determined without regard to gains) from the sale or exchange of partnership property is not allowed, except to the extent it is established that the partner's share of such losses exceeds the loss recognized by the transferor partner. In the event of successive transfers, the transferee partner's distributive share of such losses is not allowed, except to the extent that it is established that such losses exceed the loss recognized by the transferor (or any prior transferor to the extent not fully offset by a prior disallowance under this rule). Losses disallowed under this rule do not decrease the transferee partner's basis in its partnership interest. Thus, on subsequent disposition of its partnership interest, the partner's gain is reduced (or loss increased) because the basis of the partnership interest has not been reduced by such losses. The provision is applied without regard to any termination of a partnership under section 708(b)(1)(B). In the case of a basis reduction to property distributed to the transferee partner in a nonliquidating distribution, the amount of the transferor's loss taken into account under this rule is reduced by the amount of the basis reduction.

For this purpose, an electing investment partnership means a partnership that satisfies the following requirements: (1) it makes an election under the provision that is irrevocable except with the consent of the Secretary; (2) it would be an investment company under section 3(a)(1)(A) of the Investment Company Act of 1940[313] but for an exemption under paragraph (1) or (7) of section 3(c) of that Act; (3) it has never been engaged in a trade or business; (4) substantially all of its assets are held for investment; (5) at least 95 percent of the assets contributed to it consist of money; (6) no assets contributed to it had an adjusted basis in excess of fair market value at the time of contribution; (7) all partnership interests are issued by the partnership pursuant to a private offering and during the 24–month period beginning on the date of the first capital contribution to the partnership; (8) the partnership agreement has substantive restrictions on each partner's ability to cause a re-

[313] Section 3(a)(1)(A) of the Act provides, "when used in this title, 'investment company' means any issuer which is or hold itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities."

demption of the partner's interest, and (9) the partnership agreement provides for a term that is not in excess of 15 years.

The provision requires an electing investment partnership to furnish to any transferee partner the information necessary to enable the partner to compute the amount of losses disallowed under this rule.

*Distributions of partnership property*

The provision provides that a basis adjustment under section 734(b) is required in the case of a distribution with respect to which there is a substantial basis reduction. A substantial basis reduction means a downward adjustment of more than $250,000 that would be made to the basis of partnership assets if a section 754 election were in effect.

Thus, for example, assume that A and B each contributed $2.5 million to a newly formed partnership and C contributed $5 million, and that the partnership purchased LMN stock for $3 million and XYZ stock for $7 million. Assume that the value of each stock declined to $1 million. Assume LMN stock is distributed to C in liquidation of its partnership interest. Under present law, the basis of LMN stock in C's hands is $5 million. Under present law, C would recognize a loss of $4 million if the LMN stock were sold for $1 million.

Under the provision, there is a substantial basis adjustment because the $2 million increase in the adjusted basis of LMN stock (described in section 734(b)(2)(B)) is greater than $250,000. Thus, the partnership is required to decrease the basis of XYZ stock (under section 734(b)(2)) by $2 million (the amount by which the basis of LMN stock was increased), leaving a basis of $5 million. If the XYZ stock were then sold by the partnership for $1 million, A and B would each recognize a loss of $2 million.

EFFECTIVE DATE

The provision applies to contributions, distributions and transfers (as the case may be) after the date of enactment.

In the case of an electing investment partnership in existence on June 4, 2004, the requirement that the partnership agreement have substantive restrictions on redemptions does not apply, and the requirement that the partnership agreement provide for a term not exceeding 15 years is modified to permit a term not exceeding 20 years.

15. No reduction of basis under section 734 in stock held by partnership in corporate partner (sec. 634 of the bill and sec. 755 of the Code)

PRESENT LAW

*In general*

Generally, a partner and the partnership do not recognize gain or loss on a contribution of property to the partnership.[314] Similarly, a partner and the partnership generally do not recognize gain

[314] Sec. 721(a).

or loss on the distribution of partnership property.[315] This includes current distributions and distributions in liquidation of a partner's interest.

*Basis of property distributed in liquidation*

The basis of property distributed in liquidation of a partner's interest is equal to the partner's tax basis in its partnership interest (reduced by any money distributed in the same transaction).[316] Thus, the partnership's tax basis in the distributed property is adjusted (increased or decreased) to reflect the partner's tax basis in the partnership interest.

*Election to adjust basis of partnership property*

When a partnership distributes partnership property, the basis of partnership property generally is not adjusted to reflect the effects of the distribution or transfer. However, the partnership is permitted to make an election (referred to as a 754 election) to adjust the basis of partnership property in the case of a distribution of partnership property.[317] The effect of the 754 election is that the partnership adjusts the basis of its remaining property to reflect any change in basis of the distributed property in the hands of the distributee partner resulting from the distribution transaction. Such a change could be a basis increase due to gain recognition, or a basis decrease due to the partner's adjusted basis in its partnership interest exceeding the adjusted basis of the property received. If the 754 election is made, it applies to the taxable year with respect to which such election was filed and all subsequent taxable years.

In the case of a distribution of partnership property to a partner with respect to which the 754 election is in effect, the partnership increases the basis of partnership property by (1) any gain recognized by the distributee partner and (2) the excess of the adjusted basis of the distributed property to the partnership immediately before its distribution over the basis of the property to the distributee partner, and decreases the basis of partnership property by (1) any loss recognized by the distributee partner and (2) the excess of the basis of the property to the distributee partner over the adjusted basis of the distributed property to the partnership immediately before the distribution.

The allocation of the increase or decrease in basis of partnership property is made in a manner that has the effect of reducing the difference between the fair market value and the adjusted basis of partnership properties.[318] In addition, the allocation rules require that any increase or decrease in basis be allocated to partnership property of a like character to the property distributed. For this purpose, the two categories of assets are (1) capital assets and depreciable and real property used in the trade or business held for more than one year, and (2) any other property.[319]

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[315] Sec. 731(a) and (b).
[316] Sec. 732(b).
[317] Sec. 754.
[318] Sec. 755(a).
[319] Sec. 755(b).

REASONS FOR CHANGE

The Joint Committee on Taxation staff's investigative report of Enron Corporation[320] revealed that certain transactions were being undertaken that purported to use the interaction of the partnership basis adjustment rules and the rules protecting a corporation from recognizing gain on its stock to obtain unintended tax results. These transactions generally purported to increase the tax basis of depreciable assets and to decrease, by a corresponding amount, the tax basis of the stock of a partner. Because the tax rules protect a corporation from gain on the sale of its stock (including through a partnership), the transactions enable taxpayers to duplicate tax deductions at no economic cost. The provision precludes the ability to reduce the basis of corporate stock of a partner (or related party) in certain transactions.

EXPLANATION OF PROVISION

The provision provides that in applying the basis allocation rules to a distribution in liquidation of a partner's interest, a partnership is precluded from decreasing the basis of corporate stock of a partner or a related person. Any decrease in basis that, absent the provision, would have been allocated to the stock is allocated to other partnership assets. If the decrease in basis exceeds the basis of the other partnership assets, then gain is recognized by the partnership in the amount of the excess.

EFFECTIVE DATE

The provision applies to distributions after the date of enactment.

16. Repeal of special rules for FASITs, etc. (sec. 635 of the bill and secs. 860H–860L of the Code)

PRESENT LAW

*Financial asset securitization investment trusts*

In 1996, Congress created a new type of statutory entity called a "financial asset securitization trust" ("FASIT") that facilitates the securitization of debt obligations such as credit card receivables, home equity loans, and auto loans.[321] A FASIT generally is not taxable. Instead, the FASIT's taxable income or net loss flows through to the owner of the FASIT. The ownership interest of a FASIT generally is required to be held entirely by a single domestic C corporation. In addition, a FASIT generally may hold only qualified debt obligations, and certain other specified assets, and is subject to certain restrictions on its activities. An entity that qualifies as a FASIT can issue one or more classes of instruments that meet certain specified requirements and treat those instruments as debt for Federal income tax purposes.

[320] See Joint Committee on Taxation, Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations (JCS–3–03), February 2003.
[321] Sections 860H–860L.

## QUALIFICATION AS A FASIT

To qualify as a FASIT, an entity must: (1) make an election to be treated as a FASIT for the year of the election and all subsequent years;[322] (2) have assets substantially all of which (including assets that the FASIT is treated as owning because they support regular interests) are specified types called "permitted assets;" (3) have non-ownership interests be certain specified types of debt instruments called "regular interests"; (4) have a single ownership interest which is held by an "eligible holder"; and (5) not qualify as a regulated investment company ("RIC"). Any entity, including a corporation, partnership, or trust may be treated as a FASIT. In addition, a segregated pool of assets may qualify as a FASIT.

An entity ceases qualifying as a FASIT if the entity's owner ceases being an eligible corporation. Loss of FASIT status is treated as if all of the regular interests of the FASIT were retired and then reissued without the application of the rule that deems regular interests of a FASIT to be debt.

### *Permitted assets*

For an entity or arrangement to qualify as a FASIT, substantially all of its assets must consist of the following "permitted assets": (1) cash and cash equivalents; (2) certain permitted debt instruments; (3) certain foreclosure property; (4) certain instruments or contracts that represent a hedge or guarantee of debt held or issued by the FASIT; (5) contract rights to acquire permitted debt instruments or hedges; and (6) a regular interest in another FASIT. Permitted assets may be acquired at any time by a FASIT, including any time after its formation.

### *"Regular interests" of a FASIT*

"Regular interests" of a FASIT are treated as debt for Federal income tax purposes, regardless of whether instruments with similar terms issued by non-FASITs might be characterized as equity under general tax principles. To be treated as a "regular interest", an instrument generally must have fixed terms and must: (1) unconditionally entitle the holder to receive a specified principal amount; (2) pay interest that is based on (a) fixed rates, or (b) except as provided by regulations issued by the Secretary, variable rates permitted with respect to real estate mortgage investment conduit interests under section 860G(a)(1)(B)(i); (3) have a term to maturity of no more than 30 years, except as permitted by Treasury regulations; (4) be issued to the public with a premium of not more than 25 percent of its stated principal amount; and (5) have a yield to maturity determined on the date of issue of less than five percentage points above the applicable Federal rate ("AFR") for the calendar month in which the instrument is issued. Instruments that do not satisfy certain of these general requirements nevertheless may be treated as regular interests if they are held by a domestic taxable C corporation that is not a RIC, real estate investment trust ("REIT"), FASIT, or cooperative.

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[322] Once an election to be a FASIT is made, the election applies from the date specified in the election and all subsequent years until the entity ceases to be a FASIT. If an election to be a FASIT is made after the initial year of an entity, all of the assets in the entity at the time of the FASIT election are deemed contributed to the FASIT at that time and, accordingly, any gain (but not loss) on such assets will be recognized at that time.

*Transfers to FASITs*

In general, gain (but not loss) is recognized immediately by the owner of the FASIT upon the transfer of assets to a FASIT. Where property is acquired by a FASIT from someone other than the FASIT's owner (or a person related to the FASIT's owner), the property is treated as being first acquired by the FASIT's owner for the FASIT's cost in acquiring the asset from the non-owner and then transferred by the owner to the FASIT.

*Valuation rules*

In general, except in the case of debt instruments, the value of FASIT assets is their fair market value. Similarly, in the case of debt instruments that are traded on an established securities market, the market price is used for purposes of determining the amount of gain realized upon contribution of such assets to a FASIT. However, in the case of debt instruments that are not traded on an established securities market, special valuation rules apply for purposes of computing gain on the transfer of such debt instruments to a FASIT. Under these rules, the value of such debt instruments is the sum of the present values of the reasonably expected cash flows from such obligations discounted over the weighted average life of such assets. The discount rate is 120 percent of the AFR, compounded semiannually, or such other rate that the Secretary shall prescribe by regulations.

*Taxation of a FASIT*

A FASIT generally is not subject to tax. Instead, all of the FASIT's assets and liabilities are treated as assets and liabilities of the FASIT's owner and any income, gain, deduction or loss of the FASIT is allocable directly to its owner. Accordingly, income tax rules applicable to a FASIT (e.g., related party rules, sec. 871(h), sec. 165(g)(2)) are to be applied in the same manner as they apply to the FASIT's owner. The taxable income of a FASIT is calculated using an accrual method of accounting. The constant yield method and principles that apply for purposes of determining original issue discount ("OID") accrual on debt obligations whose principal is subject to acceleration apply to all debt obligations held by a FASIT to calculate the FASIT's interest and discount income and premium deductions or adjustments.

*Taxation of holders of FASIT regular interests*

In general, a holder of a regular interest is taxed in the same manner as a holder of any other debt instrument, except that the regular interest holder is required to account for income relating to the interest on an accrual method of accounting, regardless of the method of accounting otherwise used by the holder.

*Taxation of holders of FASIT ownership interests*

Because all of the assets and liabilities of a FASIT are treated as assets and liabilities of the holder of a FASIT ownership interest, the ownership interest holder takes into account all of the FASIT's income, gain, deduction, or loss in computing its taxable income or net loss for the taxable year. The character of the income to the holder of an ownership interest is the same as its character

to the FASIT, except tax-exempt interest is included in the income of the holder as ordinary income.

Although the recognition of losses on assets contributed to the FASIT is not allowed upon contribution of the assets, such losses may be allowed to the FASIT owner upon their disposition by the FASIT. Furthermore, the holder of a FASIT ownership interest is not permitted to offset taxable income from the FASIT ownership interest (including gain or loss from the sale of the ownership interest in the FASIT) with other losses of the holder. In addition, any net operating loss carryover of the FASIT owner shall be computed by disregarding any income arising by reason of a disallowed loss. Where the holder of a FASIT ownership interest is a member of a consolidated group, this rule applies to the consolidated group of corporations of which the holder is a member as if the group were a single taxpayer.

*Real estate mortgage investment conduits*

In general, a real estate mortgage investment conduit ("REMIC") is a self-liquidating entity that holds a fixed pool of mortgages and issues multiple classes of investor interests. A REMIC is not treated as a separate taxable entity. Rather, the income of the REMIC is allocated to, and taken into account by, the holders of the interests in the REMIC under detailed rules.[323] In order to qualify as a REMIC, substantially all of the assets of the entity must consist of qualified mortgages and permitted investments as of the close of the third month beginning after the startup day of the entity. A "qualified mortgage" generally includes any obligation which is principally secured by an interest in real property, and which is either transferred to the REMIC on the startup day of the REMIC in exchange for regular or residual interests in the REMIC or purchased by the REMIC within three months after the startup day pursuant to a fixed-price contract in effect on the startup day. A "permitted investment" generally includes any intangible property that is held for investment and is part of a reasonably required reserve to provide for full payment of certain expenses of the REMIC or amounts due on regular interests.

All of the interests in the REMIC must consist of one or more classes of regular interests and a single class of residual interests. A "regular interest" is an interest in a REMIC that is issued with a fixed term, designated as a regular interest, and unconditionally entitles the holder to receive a specified principal amount (or other similar amount) with interest payments that are either based on a fixed rate (or, to the extent provided in regulations, a variable rate) or consist of a specified portion of the interest payments on qualified mortgages that does not vary during the period such interest is outstanding. In general, a "residual interest" is any interest in the REMIC other than a regular interest, and which is so designated by the REMIC, provided that there is only one class of such interest and that all distributions (if any) with respect to such interests are pro rata. Holders of residual REMIC interests are subject to tax on the portion of the income of the REMIC that is not allocated to the regular interest holders.

[323] See sections 860A–860G.

REASONS FOR CHANGE

The Joint Committee on Taxation staff's investigative report of Enron Corporation[324] described two structured tax-motivated transactions—Projects Apache and Renegade—that Enron undertook in which the use of a FASIT was a key component in the structure of the transactions. The Committee is aware that FASITs are not being used widely in the manner envisioned by the Congress and, consequently, the FASIT rules have not served the purpose for which they originally were intended. Moreover, the Joint Committee staff's report and other information indicate that FASITs are particularly prone to abuse and likely are being used primarily to facilitate tax avoidance transactions.[325] Therefore, the Committee believes that the potential for abuse that is inherent in FASITs far outweighs any beneficial purpose that the FASIT rules may serve. Accordingly, the Committee believes that these rules should be repealed, with appropriate transition relief for existing FASITs and appropriate modifications to the present-law REMIC rules to permit the use of REMICs by taxpayers that have relied upon FASITs to securitize certain obligations secured by interests in real property.

EXPLANATION OF PROVISION

The provision repeals the special rules for FASITs. The provision provides a transition period for existing FASITs, pursuant to which the repeal of the FASIT rules generally does not apply to any FASIT in existence on the date of enactment to the extent that regular interests issued by the FASIT prior to such date continue to remain outstanding in accordance with their original terms.

For purposes of the REMIC rules, the provision also modifies the definitions of REMIC regular interests, qualified mortgages, and permitted investments so that certain types of real estate loans and loan pools can be transferred to, or purchased by, a REMIC. Specifically, the provision modifies the present-law definition of a REMIC "regular interest" to provide that an interest in a REMIC does not fail to qualify as a regular interest solely because the specified principal amount of such interest or the amount of interest accrued on such interest could be reduced as a result of the nonoccurrence of one or more contingent payments with respect to one or more reverse mortgages loans, as defined below, that are held by the REMIC, provided that on the startup day for the REMIC, the REMIC sponsor reasonably believes that all principal and interest due under the interest will be paid at or prior to the liquidation of the REMIC. For this purpose, a reasonable belief concerning ultimate payment of all amounts due under an interest is presumed to exist if, as of the startup day, the interest receives an investment grade rating from at least one nationally recognized statistical rating agency.

[324] See Joint Committee on Taxation, Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations (JCS–3–03), February 2003.

[325] For example, the Committee is aware that FASITs also have been used to facilitate the issuance of certain tax-advantaged cross-border hybrid instruments that are treated as indebtedness in the United States but equity in the foreign country of the holder of the instruments. Congress did not intend such use of FASITs when it enacted the FASIT rules.

In addition, the provision makes three modifications to the present-law definition of a "qualified mortgage." First, the provision modifies the definition to include an obligation principally secured by real property which represents an increase in the principal amount under the original terms of an obligation, provided such increase: (1) is attributable to an advance made to the obligor pursuant to the original terms of the obligation; (2) occurs after the REMIC startup day; and (3) is purchased by the REMIC pursuant to a fixed price contract in effect on the startup day. Second, the provision modifies the definition to generally include reverse mortgage loans and the periodic advances made to obligors on such loans. For this purpose, a "reverse mortgage loan" is defined as a loan that: (1) is secured by an interest in real property; (2) provides for one or more advances of principal to the obligor (each such advance giving rise to a "balance increase"), provided such advances are principally secured by an interest in the same real property as that which secures the loan; (3) may provide for a contingent payment at maturity based upon the value or appreciation in value of the real property securing the loan; (4) provides for an amount due at maturity that cannot exceed the value, or a specified fraction of the value, of the real property securing the loan; (5) provides that all payments under the loan are due only upon the maturity of the loan; and (6) matures after a fixed term or at the time the obligor ceases to use as a personal residence the real property securing the loan. Third, the provision modifies the definition to provide that, if more than 50 percent of the obligations transferred to, or purchased by, the REMIC are (1) originated by the United States or any State (or any political subdivision, agency, or instrumentality of the United States or any State) and (2) principally secured by an interest in real property, then each obligation transferred to, or purchased by, the REMIC shall be treated as secured by an interest in real property.

In addition, the provision modifies the present-law definition of a "permitted investment" to include intangible investment property held as part of a reasonably required reserve to provide a source of funds for the purchase of obligations described above as part of the modified definition of a "qualified mortgage."

EFFECTIVE DATE

Except as provided by the transition period for existing FASITs, the provision is effective on January 1, 2005.

17. Limitation on transfer of built-in losses on REMIC residuals (sec. 636 of the bill and sec. 362 of the Code)

PRESENT LAW

Generally, no gain or loss is recognized when one or more persons transfer property to a corporation in exchange for stock and immediately after the exchange such person or persons control the corporation.[326] The transferor's basis in the stock of the controlled corporation is the same as the basis of the property contributed to the controlled corporation, increased by the amount of any gain (or dividend) recognized by the transferor on the exchange, and re-

[326] Sec. 351.

duced by the amount of any money or property received, and by the amount of any loss recognized by the transferor.[327] The basis of property received by a controlled corporation in a tax-free transfer to the corporation is the same as the adjusted basis in the hands of the transferor, adjusted for gain or loss recognized by the transferor.[328]

REASONS FOR CHANGE

The Joint Committee on Taxation staff's investigative report of Enron Corporation[329] revealed that Enron was using REMIC residual interests in tax motivated transactions to purportedly duplicate a single economic loss and deduct the loss more than once. The Committee understands that, under the statutory rules regarding the taxation of REMICS, phantom income is allocated to REMIC residual interest holders. Because of the associated basis increases in the REMIC residual interests, the phantom income allocation inevitably creates built-in losses to the holders of the REMIC residual interests, thus making such interests a natural component of transactions designed to duplicate a single economic loss. Congress did not intend REMIC residual interests to be used in this manner. Therefore, the Committee believes that a corporation's basis in REMIC residual interests acquired in a tax-free transfer should be limited to the fair market value of such interests.

EXPLANATION OF PROVISION

The provision provides that if a residual interest (as defined in section 860G(a)(2)) in a real estate mortgage investment conduit ("REMIC") is contributed to a corporation and the transferee corporation's adjusted basis in the REMIC residual interest would (but for the provision) exceed the fair market value of the REMIC residual interest immediately after the contribution, the transferee corporation's adjusted basis in the REMIC residual interest is limited to the fair market value of the REMIC residual interest immediately after the contribution, regardless of whether the fair market value of the REMIC residual interest is less than, equal to, or greater than zero (i.e., the provision may result in the transferee corporation having a negative adjusted basis in the REMIC residual interest).

EFFECTIVE DATE

The provision applies to transactions after the date of enactment.

[327] Sec. 358.
[328] Sec. 362(a).
[329] See Joint Committee on Taxation, Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations (JCS–3–03), February 2003.

## 18. Clarification of banking business for purposes of determining investment of earnings in U.S. property (sec. 637 of the bill and sec. 956 of the Code)

### PRESENT LAW

In general, the subpart F rules[330] require the U.S. 10-percent shareholders of a controlled foreign corporation to include in income currently their pro rata shares of certain income of the controlled foreign corporation (referred to as "subpart F income"), whether or not such earnings are distributed currently to the shareholders. In addition, the U.S. 10-percent shareholders of a controlled foreign corporation are subject to U.S. tax currently on their pro rata shares of the controlled foreign corporation's earnings to the extent invested by the controlled foreign corporation in certain U.S. property.[331]

A shareholder's current income inclusion with respect to a controlled foreign corporation's investment in U.S. property for a taxable year is based on the controlled foreign corporation's average investment in U.S. property for such year. For this purpose, the U.S. property held (directly or indirectly) by the controlled foreign corporation must be measured as of the close of each quarter in the taxable year.[332] The amount taken into account with respect to any property is the property's adjusted basis as determined for purposes of reporting the controlled foreign corporation's earnings and profits, reduced by any liability to which the property is subject. The amount determined for current inclusion is the shareholder's pro rata share of an amount equal to the lesser of: (1) the controlled foreign corporation's average investment in U.S. property as of the end of each quarter of such taxable year, to the extent that such investment exceeds the foreign corporation's earnings and profits that were previously taxed on that basis; or (2) the controlled foreign corporation's current or accumulated earnings and profits (but not including a deficit), reduced by distributions during the year and by earnings that have been taxed previously as earnings invested in U.S. property.[333] An income inclusion is required only to the extent that the amount so calculated exceeds the amount of the controlled foreign corporation's earnings that have been previously taxed as subpart F income.[334]

For purposes of section 956, U.S. property generally is defined to include tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person, and certain intangible assets including a patent or copyright, an invention, model or design, a secret formula or process or similar property right which is acquired or developed by the controlled foreign corporation for use in the United States.[335]

Specified exceptions from the definition of U.S. property are provided for: (1) obligations of the United States, money, or deposits with persons carrying on the banking business; (2) certain export property; (3) certain trade or business obligations; (4) aircraft, rail-

[330] Secs. 951–964.
[331] Sec. 951(a)(1)(B).
[332] Sec. 956(a).
[333] Secs. 956 and 959.
[334] Secs. 951(a)(1)(B) and 959.
[335] Sec. 956(c)(1).

road rolling stock, vessels, motor vehicles or containers used in transportation in foreign commerce and used predominantly outside of the United States; (5) certain insurance company reserves and unearned premiums related to insurance of foreign risks; (6) stock or debt of certain unrelated U.S. corporations; (7) moveable property (other than a vessel or aircraft) used for the purpose of exploring, developing, or certain other activities in connection with the ocean waters of the U.S. Continental Shelf; (8) an amount of assets equal to the controlled foreign corporation's accumulated earnings and profits attributable to income effectively connected with a U.S. trade or business; (9) property (to the extent provided in regulations) held by a foreign sales corporation and related to its export activities; (10) certain deposits or receipts of collateral or margin by a securities or commodities dealer, if such deposit is made or received on commercial terms in the ordinary course of the dealer's business as a securities or commodities dealer; and (11) certain repurchase and reverse repurchase agreement transactions entered into by or with a dealer in securities or commodities in the ordinary course of its business as a securities or commodities dealer.[336]

With regard to the exception for deposits with persons carrying on the banking business, the U.S. Court of Appeals for the Sixth Circuit in *The Limited, Inc.* v. *Commissioner*[337] concluded that a U.S. subsidiary of a U.S. shareholder was "carrying on the banking business" even though its operations were limited to the administration of the private label credit card program of the U.S. shareholder. Therefore, the court held that a controlled foreign corporation of the U.S. shareholder could make deposits with the subsidiary (e.g., through the purchase of certificates of deposit) under this exception, and avoid taxation of the deposits under section 956 as an investment in U.S. property.

REASONS FOR CHANGE

The Committee believes that further guidance is necessary under the U.S. property investment provisions of subpart F with regard to the treatment of deposits with persons carrying on the banking business. In particular, the Committee believes that the transaction at issue in *The Limited* case was not contemplated or intended by Congress when it excepted from the definition of U.S. property deposits with persons carrying on the banking business. Therefore, the Committee believes that it is appropriate and necessary to clarify the scope of this exception so that it applies only to deposits with genuine banking businesses and their affiliates.

EXPLANATION OF PROVISION

The provision provides that the exception from the definition of U.S. property under section 956 for deposits with persons carrying on the banking business is limited to deposits with persons at least 80 percent of the gross income of which is derived in the active conduct of a banking business from unrelated persons. For purposes of applying this provision, the deposit recipient and all persons re-

[336] Sec. 956(c)(2).
[337] 286 F.3d 324 (6th Cir. 2002), rev'g 113 T.C. 169 (1999).

lated to the deposit recipient are treated as one person in applying the 80-percent test.

No inference is intended as to the meaning of the phrase "carrying on the banking business" under present law.

EFFECTIVE DATE

This provision is effective on the date of enactment.

19. Alternative tax for certain small insurance companies (sec. 638 of the bill and sec. 831 of the Code)

PRESENT LAW

A property and casualty insurance company generally is subject to tax on its taxable income (sec. 831(a)). The taxable income of a property and casualty insurance company is determined as the sum of its underwriting income and investment income (as well as gains and other income items), reduced by allowable deductions (sec. 832).

A property and casualty insurance company may elect to be taxed only on taxable investment income if its net written premiums or direct written premiums (whichever is greater) do not exceed $1.2 million (sec. 831(b)). For purposes of determining the amount of a company's net written premiums or direct written premiums under this rule, premiums received by all members of a controlled group of corporations (as defined in section 831(b)) of which the company is a part are taken into account (including gross receipts of foreign and tax-exempt corporations).

REASONS FOR CHANGE

The Committee believes that the $1.2 million ceiling on net written premiums or direct written premiums of property and casualty insurance companies electing to be taxed only on taxable investment income should be increased to reflect inflation in recent years,[338] and should be indexed to take account of future inflation.

EXPLANATION OF PROVISION

Under the provision, the $1.2 million ceiling on net written premiums or direct written premiums for purposes of the election to be taxed only on taxable investment income is increased to $1.89 million, and is indexed for taxable years beginning in a calendar year after 2004.

EFFECTIVE DATE

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

[338] In 1986, the ceiling was set at $1.2 million and the provision was expanded to apply to both stock and mutual property and casualty insurance companies (sec. 1024 of Pub. L. No. 99–514, the "Tax Reform Act of 1986").

20. Denial of deduction for interest on underpayments attributable to nondisclosed reportable transactions (sec. 639 of the bill and sec. 163 of the Code)

PRESENT LAW

In general, corporations may deduct interest paid or accrued within a taxable year on indebtedness.[339] Interest on indebtedness to the Federal government attributable to an underpayment of tax generally may be deducted pursuant to this provision.

REASONS FOR CHANGE

The Committee believes that it is inappropriate for corporations to deduct interest paid to the Government with respect to certain tax shelter transactions.

EXPLANATION OF PROVISION

The provision disallows any deduction for interest paid or accrued within a taxable year on any portion of an underpayment of tax that is attributable to an understatement arising from an undisclosed listed transaction or from an undisclosed reportable avoidance transaction (other than a listed transaction).[340]

EFFECTIVE DATE

The provision is effective for underpayments attributable to transactions entered into in taxable years beginning after the date of enactment.

21. Clarification of rules for payment of estimated tax for certain deemed asset sales (sec. 640 of the bill and sec. 338 of the Code)

PRESENT LAW

In certain circumstances, taxpayers can make an election under section 338(h)(10) to treat a qualifying purchase of 80 percent of the stock of a target corporation by a corporation from a corporation that is a member of an affiliated group (or a qualifying purchase of 80 percent of the stock of an S corporation by a corporation from S corporation shareholders) as a sale of the assets of the target corporation, rather than as a stock sale. The election must be made jointly by the buyer and seller of the stock and is due by the 15th day of the ninth month beginning after the month in which the acquisition date occurs. An agreement for the purchase and sale of stock often may contain an agreement of the parties to make a section 338(h)(10) election.

Section 338(a) also permits a unilateral election by a buyer corporation to treat a qualified stock purchase of a corporation as a deemed asset acquisition, whether or not the seller of the stock is a corporation (or an S corporation is the target). In such a case, the seller or sellers recognize gain or loss on the stock sale (including

[339] Sec. 163(a).

[340] The definitions of these transactions are the same as those previously described in connection with the provision elsewhere in this bill to modify the accuracy-related penalty for listed and certain reportable transactions.

any estimated taxes with respect to the stock sale), and the target corporation recognizes gain or loss on the deemed asset sale.

Section 338(h)(13) provides that, for purposes of section 6655 (relating to additions to tax for failure by a corporation to pay estimated income tax), tax attributable to a deemed asset sale under section 338(a)(1) shall not be taken into account.

REASONS FOR CHANGE

The Committee is concerned that some taxpayers may inappropriately be taking the position that estimated tax and the penalty (computed in the amount of an interest charge) under section 6655 applies neither to the stock sale nor to the asset sale in the case of a section 338(h)(10) election. The Committee believes that estimated tax should not be avoided merely because an election may be made under section 338(h)(10). Furthermore, the Committee understands that parties typically negotiate a sale with an understanding as to whether or not an election under section 338(h)(10) will be made. In the event there is a contingency in this regard, the parties may provide for adjustments to the price to reflect the effect of the election.

EXPLANATION OF PROVISION

The provision clarifies section 338(h)(13) to provide that the exception for estimated tax purposes with respect to tax attributable to a deemed asset sale does not apply with respect to a qualified stock purchase for which an election is made under section 338(h)(10).

Under the provision, if a qualified stock purchase transaction eligible for the election under section 338(h)(10) occurs, estimated tax would be determined based on the stock sale unless and until there is an agreement of the parties to make a section 338(h)(10) election.

If at the time of the sale there is an agreement of the parties to make a section 338(h)(10) election, then estimated tax is computed based on an asset sale, computed from the date of the sale.

If the agreement to make a section 338(h)(10) election is concluded after the stock sale, such that the original computation was based on the stock sale, estimated tax is recomputed based on the asset sale election.

No inference is intended as to present law.

EFFECTIVE DATE

The provision is effective for qualified stock purchase transactions that occur after the date of enactment.

22. Exclusion of like-kind exchange property from nonrecognition treatment on the sale or exchange of a principal residence (sec. 641 of the bill and sec. 121 of the Code)

PRESENT LAW

Under present law, a taxpayer may exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence.[341] To be eligible for the

[341] Sec. 121.

exclusion, the taxpayer must have owned and used the residence as a principal residence for at least two of the five years prior to the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or, to the extent provided under regulations, unforeseen circumstances is able to exclude an amount equal to the fraction of the $250,000 ($500,000 if married filing a joint return) that is equal to the fraction of the two years that the ownership and use requirements are met. There are no special rules relating to the sale or exchange of a principal residence that was acquired in a like-kind exchange within the prior five years.

REASONS FOR CHANGE

The Committee believes that the present-law exclusion of gain allowable upon the sale or exchange of principal residences serves an important role in encouraging home ownership. The Committee does not believe that this exclusion is appropriate for properties that were recently acquired in like-kind exchanges. Under the like-kind exchange rules, a taxpayer that exchanges property that was held for productive use or investment for like-kind property may acquire the replacement property on a tax-free basis. Because the replacement property generally has a low carry-over tax basis, the taxpayer will have taxable gain upon the sale or exchange of the replacement property. However, when the taxpayer converts the replacement property into the taxpayer's principal residence, the taxpayer may shelter some or all of this gain from income taxation. The Committee believes that this provision balances the concerns associated with these provisions to reduce this tax shelter concern without unduly limiting the exclusion on sales or exchanges of principal residences.

EXPLANATION OF PROVISION

The bill provides that the exclusion for gain on the sale or exchange of a principal residence does not apply if the principal residence was acquired in a like-kind exchange in which any gain was not recognized within the prior five years.

EFFECTIVE DATE

The provision is effective for sales or exchanges of principal residences after the date of enactment.

23. Prevention of mismatching of interest and original issue discount deductions and income inclusions in transactions with related foreign persons (sec. 642 of the bill and secs. 163 and 267 of the Code)

PRESENT LAW

Income earned by a foreign corporation from its foreign operations generally is subject to U.S. tax only when such income is distributed to any U.S. person that holds stock in such corporation. Accordingly, a U.S. person that conducts foreign operations through a foreign corporation generally is subject to U.S. tax on the income from such operations when the income is repatriated to the United States through a dividend distribution to the U.S. person. The income is reported on the U.S. person's tax return for the year the

distribution is received, and the United States imposes tax on such income at that time. However, certain anti-deferral regimes may cause the U.S. person to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by the foreign corporations in which the U.S. person holds stock. The main anti-deferral regimes are the controlled foreign corporation rules of subpart F (secs. 951–964), the passive foreign investment company rules (secs. 1291–1298), and the foreign personal holding company rules (secs. 551–558).

As a general rule, there is allowed as a deduction all interest paid or accrued within the taxable year with respect to indebtedness, including the aggregate daily portions of original issue discount ("OID") of the issuer for the days during such taxable year.[342] However, if a debt instrument is held by a related foreign person, any portion of such OID is not allowable as a deduction to the payor of such instrument until paid ("related-foreign-person rule"). This related-foreign-person rule does not apply to the extent that the OID is effectively connected with the conduct by such foreign related person of a trade or business within the United States (unless such OID is exempt from taxation or is subject to a reduced rate of taxation under a treaty obligation).[343] Treasury regulations further modify the related-foreign-person rule by providing that in the case of a debt owed to a foreign personal holding company ("FPHC"), controlled foreign corporation ("CFC") or passive foreign investment company ("PFIC"), a deduction is allowed for OID as of the day on which the amount is includible in the income of the FPHC, CFC or PFIC, respectively.[344]

In the case of unpaid stated interest and expenses of related persons, where, by reason of a payee's method of accounting, an amount is not includible in the payee's gross income until it is paid but the unpaid amounts are deductible currently by the payor, the amount generally is allowable as a deduction when such amount is includible in the gross income of the payee.[345] With respect to stated interest and other expenses owed to related foreign corporations, Treasury regulations provide a general rule that requires a taxpayer to use the cash method of accounting with respect to the deduction of amounts owed to such related foreign persons (with an exception for income of a related foreign person that is effectively connected with the conduct of a U.S. trade or business and that is not exempt from taxation or subject to a reduced rate of taxation under a treaty obligation).[346] As in the case of OID, the Treasury regulations additionally provide that in the case of stated interest owed to a FPHC, CFC, or PFIC, a deduction is allowed as of the day on which the amount is includible in the income of the FPHC, CFC or PFIC.[347]

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[342] Sec. 163(e)(1).

[343] Sec. 163(e)(3).

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

[345] Sec. 267(a)(2).

[346] Treas. Reg. sec. 1.267(a)–3(b)(1), –3(c).

[347] Treas. Reg. sec. 1.267(a)–3(c)(4).

REASONS FOR CHANGE

The special rules in the Treasury regulations for FPHCs, CFCs and PFICs are exceptions to the general rule that OID and unpaid interest owed to a related foreign person are deductible when paid (i.e., under the cash method). These special rules were deemed appropriate in the case of FPHCs, CFCs and PFICs because it was thought that there would be little material distortion in matching of income and deductions with respect to amounts owed to a related foreign corporation that is required to determine its taxable income and earnings and profits for U.S. tax purposes pursuant to the FPHC, subpart F or PFIC provisions. The Committee believes that this premise fails to take into account the situation where amounts owed to the related foreign corporation are included in the income of the related foreign corporation but are not currently included in the income of the related foreign corporation's U.S. shareholder. Consequently, under the Treasury regulations, both the U.S. payors and U.S.-owned foreign payors may be able to accrue deductions for amounts owed to related FPHCs, CFCs or PFICs without the U.S. owners of such related entities taking into account for U.S. tax purposes a corresponding amount of income. These deductions can be used to reduce U.S. income or, in the case of a U.S.-owned foreign payor, to reduce earnings and profits which could reduce a CFC's income that would be currently taxable to its U.S. shareholders under subpart F.

EXPLANATION OF PROVISION

The provision provides that deductions for amounts accrued but unpaid (whether by U.S. or foreign persons) to related FPHCs, CFCs, or PFICs are allowable only to the extent that the amounts accrued by the payor are, for U.S. tax purposes, currently includible in the income of the direct or indirect U.S. owners of the related foreign corporation under the relevant inclusion rules.[348] Deductions that have accrued but are not allowable under this provision are allowed when the amounts are paid.

For purposes of determining how much of the amount accrued, if any, is currently includible in the income of a U.S. person under the relevant inclusion rules, properly allowable deductions of the related foreign corporation and qualified deficits under section 952(c)(1)(B) are taken into account. For this purpose, properly allowable deductions of the related foreign corporation are those expenses, losses, or other deductible amounts of the foreign corporation that are properly allocable, under the principles of section 954(b)(5), to the relevant income of the foreign corporation.

For example, assume the following facts. A U.S. parent corporation accrues an expense item of 100 to its 60-percent owned CFC. The item constitutes foreign base company income in the hands of the CFC. An unrelated foreign corporation owns the remaining 40 percent interest in the CFC. The item is the only potential subpart F income of the CFC and has not been paid by the end of the taxable year of the parent. Expenses of 60 are properly allocated or apportioned to the 100 of foreign base company income under the

[348] Section 313 of the bill repeals the foreign personal holding company regime, effective for taxable years of foreign corporations beginning after December 31, 2004, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

principles of section 954(b)(5). In addition, other income and expense items of the CFC net to a loss of 30, which, when taken together with the 40 (100 − 60) of net foreign base company income, results in current net income for the CFC of 10. Assuming further that the CFC has no current earnings and profits adjustments, the CFC's subpart F income in this case is limited to 10, six of which is includible in the gross income of the U.S. parent as its pro rata share of subpart F income. Under these facts, the U.S. parent is allowed a current deduction of 42 ((10 + 60) × 60%) under this provision. If the other income and expense items of the CFC net to a loss of 50 instead of 30, the U.S. parent would instead be allowed a current deduction of 30 ((40 − 50 + 60) × 60%).

The provision grants the Secretary regulatory authority to provide exceptions to these rules, including an exception for amounts accrued where payment of the amount accrued occurs within a short period after accrual, and the transaction giving rise to the payment is entered into by the payor in the ordinary course of a business in which the payor is predominantly engaged.

EFFECTIVE DATE

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

24. Exclusion from gross income for interest on overpayments of income tax by individuals (sec. 643 of the bill and new sec. 139A of the Code)

PRESENT LAW

*Overpayment interest*

Interest is included in the list of items that are required to be included in gross income (sec. 61(a)(4)). Interest on overpayments of Federal income tax is required to be included in taxable income in the same manner as any other interest that is received by the taxpayer.

Cash basis taxpayers are required to report overpayment interest as income in the period the interest is received. Accrual basis taxpayers are required to report overpayment interest as income when all events fixing the right to the receipt of the overpayment interest have occurred and the amount can be estimated with reasonable accuracy. Generally, this occurs on the date the appropriate IRS official signs the pertinent schedule of overassessments.

*Underpayment interest*

A corporate taxpayer is allowed to currently take into account interest paid on underpayments of Federal income tax as an ordinary and necessary business expense. Typically, this results in a current deduction. However, the deduction may be deferred if the interest is required to be capitalized or may be disallowed if and to the extent it is determined to be a cost of earning tax exempt income under section 265.

Section 163(h) of the Code prohibits the deduction of personal interest by taxpayers other than corporations. Noncorporate taxpayers, including individuals, generally are not allowed to deduct interest on the underpayment of Federal income taxes.

Temporary regulations provide that personal interest includes interest paid on underpayments of individual Federal, State or local income taxes, regardless of the source of the income generating the tax liability. This is consistent with the statement in the General Explanation of the Tax Reform Act of 1986 that "(p)ersonal interest also includes interest on underpayments of individual Federal, State, or local income taxes notwithstanding that all or a portion of the income may have arisen in a trade or business, because such taxes are not considered derived from conduct of a trade or business." The validity of the temporary regulation has been upheld in those Circuits that have considered the issue, including the Fourth, Fifth, Sixth, Seventh, Eighth, and Ninth Circuits.

Personal interest also includes interest that is paid by a trust, S corporation, or other pass-through entity on underpayments of State or local income taxes. Personal interest does not include interest that is paid with respect to sales, excise or similar taxes that are incurred in connection with a trade or business or an investment activity.

### REASONS FOR CHANGE

The Committee believes that there should be consistency in the treatment of interest paid by the Federal government to an individual taxpayer and interest paid by an individual taxpayer to the Federal government. Allowing individual taxpayers to exclude interest on overpayments will treat all individual taxpayers consistently, whether or not they itemize deductions.

### EXPLANATION OF PROVISION

The bill excludes overpayment interest that is paid to individual taxpayers on overpayments of Federal income tax from gross income. Interest excluded under the provision is not considered disqualified income that could limit the earned income credit. Interest excluded under the provision also is not considered in determining what portion of a taxpayer's social security or tier 1 railroad retirement benefits are subject to tax (sec. 86), whether a taxpayer has sufficient taxable income to be required to file a return (sec. 6012(d)), or for any other computation in which interest exempt from tax is otherwise required to be added to adjusted gross income.

The exclusion from income of overpayment interest does not apply if the Secretary determines that the taxpayer's principal purpose for overpaying his or her tax is to take advantage of the exclusion.

For example, a taxpayer prepares his return without taking into account significant itemized deductions of which he is, or should be, aware. Before the expiration of the statute of limitations, the taxpayer files an amended return claiming these itemized deductions and requesting a refund with interest. Unless the taxpayer can establish a principal purpose for originally overpaying the tax other than collecting excludible interest, the Secretary may determine that the principal purpose of waiting to claim the deductions on an amended return was to earn interest that would be excluded from income. In that case, the interest on the overpayment could not be excluded from income.

It is expected that the Secretary will indicate whether the interest is eligible to be excluded from income on the Form 1099 it provides that taxpayer for the taxable year in which the underpayment interest is paid.

EFFECTIVE DATE

The provision is effective for interest received in calendar years beginning after the date of enactment.

25. Deposits made to suspend the running of interest on potential underpayments (sec. 644 of the bill and new sec. 6603 of the Code)

PRESENT LAW

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

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

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

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

A deposit in the nature of a cash bond will stop the running of interest on an amount of underpayment equal to the deposit, but the deposit does not itself earn interest. A deposit in the nature of a cash bond is not a payment of tax and is not subject to a claim for credit or refund. A deposit in the nature of a cash bond may be made for all or part of the disputed liability and generally may be recovered by the taxpayer prior to a final determination. However, a deposit in the nature of a cash bond need not be refunded to the extent the Secretary determines that the assessment or collection of the tax determined would be in jeopardy, or that the deposit should be applied against another liability of the taxpayer in the same manner as an overpayment of tax. If the taxpayer recov-

ers the deposit prior to final determination and a deficiency is later determined, the taxpayer will not receive credit for the period in which the funds were held as a deposit. The taxable year to which the deposit in the nature of a cash bond relates must be designated, but the taxpayer may request that the deposit be applied to a different year under certain circumstances.

REASONS FOR CHANGE

The Committee believes that taxpayers should be able to limit their underpayment interest exposure in a tax dispute. An improved deposit system will help taxpayers better manage their exposure to underpayment interest without requiring them to surrender access to their funds or requiring them to make a potentially indefinite-term investment in a non-interest bearing account. The Committee believes that an improved deposit system that allows for the payment of interest on amounts that are not ultimately needed to offset tax liability when the taxpayer's position is upheld, as well as allowing for the offset of tax liability when the taxpayer's position fails, will provide an effective way for taxpayers to manage their exposure to underpayment interest. However, the Committee believes that such an improved deposit system should be reserved for the issues that are known to both parties, either through IRS examination or voluntary taxpayer disclosure.

EXPLANATION OF PROVISION

*In general*

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

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

*Use of a deposit to offset underpayments of tax*

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

For example, assume a calendar year individual taxpayer deposits $20,000 on May 15, 2005, with respect to a disputable item on its 2004 income tax return. On April 15, 2007, an examination of the taxpayer's year 2004 income tax return is completed, and the taxpayer and the IRS agree that the taxable year 2004 taxes were underpaid by $25,000. The $20,000 on deposit is used to pay $20,000 of the underpayment, and the taxpayer also pays the remaining $5,000. In this case, the taxpayer will owe underpayment interest from April 15, 2005 (the original due date of the return) to the date of payment (April 15, 2007) only with respect to the

$5,000 of the underpayment that is not paid by the deposit. The taxpayer will owe underpayment interest on the remaining $20,000 of the underpayment only from April 15, 2005, to May 15, 2005, the date the $20,000 was deposited.

*Withdrawal of amounts*

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

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

*Limitation on amounts for which interest may be allowed*

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

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

*Deposits are not payments of tax*

A deposit is not a payment of tax prior to the time the deposited amount is used to pay a tax. Similarly, withdrawal of a deposit will not establish a period for which interest was allowable at the short-term applicable Federal rate for the purpose of establishing a net

zero interest rate on a similar amount of underpayment for the same period.

EFFECTIVE DATE

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

26. Authorize IRS to enter into installment agreements that provide for partial payment (sec. 645 of the bill and sec. 6159 of the Code)

PRESENT LAW

The Code authorizes the IRS to enter into written agreements with any taxpayer under which the taxpayer is allowed to pay taxes owed, as well as interest and penalties, in installment payments if the IRS determines that doing so will facilitate collection of the amounts owed (sec. 6159). An installment agreement does not reduce the amount of taxes, interest, or penalties owed. Generally, during the period installment payments are being made, other IRS enforcement actions (such as levies or seizures) with respect to the taxes included in that agreement are held in abeyance.

Prior to 1998, the IRS administratively entered into installment agreements that provided for partial payment (rather than full payment) of the total amount owed over the period of the agreement. In that year, the IRS Chief Counsel issued a memorandum concluding that partial payment installment agreements were not permitted.

REASONS FOR CHANGE

According to the Department of the Treasury, at the end of fiscal year 2003, the IRS had not pursued 2.25 million cases totaling more than $16.5 billion in delinquent taxes. The Committee believes that clarifying that the IRS is authorized to enter into installment agreements with taxpayers that do not provide for full payment of the taxpayer's liability over the life of the agreement will improve effective tax administration.

The Committee recognizes that some taxpayers are unable or unwilling to enter into a realistic offer-in-compromise. The Committee believes that these taxpayers should be encouraged to make partial payments toward resolving their tax liability, and that providing for partial payment installment agreements will help facilitate this.

EXPLANATION OF PROVISION

The provision clarifies that the IRS is authorized to enter into installment agreements with taxpayers which do not provide for full payment of the taxpayer's liability over the life of the agreement. The provision also requires the IRS to review partial payment installment agreements at least every two years. The primary purpose of this review is to determine whether the financial condition of the taxpayer has significantly changed so as to warrant an increase in the value of the payments being made.

EFFECTIVE DATE

The provision is effective for installment agreements entered into on or after the date of enactment.

27. Affirmation of consolidated return regulation authority (sec. 646 of the bill and sec. 1502 of the Code)

PRESENT LAW

An affiliated group of corporations may elect to file a consolidated return in lieu of separate returns. A condition of electing to file a consolidated return is that all corporations that are members of the consolidated group must consent to all the consolidated return regulations prescribed under section 1502 prior to the last day prescribed by law for filing such return.[349]

Section 1502 states:

> The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent the avoidance of such tax liability.[350]

Under this authority, the Treasury Department has issued extensive consolidated return regulations.[351]

In the recent case of *Rite Aid Corp.* v. *United States,*[352] the Federal Circuit Court of Appeals addressed the application of a particular provision of certain consolidated return loss disallowance regulations, and concluded that the provision was invalid.[353] The

[349] Sec. 1501.

[350] Sec. 1502.

[351] Regulations issued under the authority of section 1502 are considered to be "legislative" regulations rather than "interpretative" regulations, and as such are usually given greater deference by courts in case of a taxpayer challenge to such a regulation. See, S. Rep. No. 960, 70th Cong., 1st Sess. at 15 (1928), describing the consolidated return regulations as "legislative in character". The Supreme Court has stated that ". . . legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute." *Chevron, U.S.A., Inc.* v. *Natural Resources Defense Council, Inc.,* 467 U.S. 837, 844 (1984) (involving an environmental protection regulation). For examples involving consolidated return regulations, see, e.g., *Wolter Construction Company* v. *Commissioner,* 634 F.2d 1029 (6th Cir. 1980); *Garvey, Inc.* v. *United States,* 1 Ct. Cl. 108 (1983), aff'd 726 F.2d 1569 (Fed. Cir. 1984), cert. denied, 469 U.S. 823 (1984). Compare, e.g., *Audrey J. Walton* v. *Commissioner,* 115 T.C. 589 (2000), describing different standards of review. The case did not involve a consolidated return regulation.

[352] 255 F.3d 1357 (Fed. Cir. 2001), reh'g denied, 2001 U.S. App. LEXIS 23207 (Fed. Cir. Oct. 3, 2001).

[353] Prior to this decision, there had been a few instances involving prior laws in which certain consolidated return regulations were held to be invalid. See, e.g., *American Standard, Inc.* v. *United States,* 602 F.2d 256 (Ct. Cl. 1979), discussed in the text infra. See also *Union Carbide Corp.* v. *United States,* 612 F.2d 558 (Ct. Cl. 1979), and *Allied Corporation* v. *United States*, 685 F. 2d 396 (Ct. Cl. 1982), all three cases involving the allocation of income and loss within a consolidated group for purposes of computation of a deduction allowed under prior law by the Code for Western Hemisphere Trading Corporations. See also *Joseph Weidenhoff* v. *Commissioner*, 32 T.C. 1222, 1242–1244 (1959), involving the application of certain regulations to the excess profits tax credit allowed under prior law, and concluding that the Commissioner had applied a particular regulation in an arbitrary manner inconsistent with the wording of the regulation and inconsistent with even a consolidated group computation. Cf. *Kanawha Gas & Utilities Co.* v. *Commissioner,* 214 F.2d 685 (1954), concluding that the substance of a transaction was an acquisition of assets rather than stock. Thus, a regulation governing basis of the assets of consolidated subsidiaries did not apply to the case. See also *General Machinery Corporation*

particular provision, known as the "duplicated loss" provision,[354] would have denied a loss on the sale of stock of a subsidiary by a parent corporation that had filed a consolidated return with the subsidiary, to the extent the subsidiary corporation had assets that had a built-in loss, or had a net operating loss, that could be recognized or used later.[355]

The Federal Circuit Court opinion contained language discussing the fact that the regulation produced a result different than the result that would have obtained if the corporations had filed separate returns rather than consolidated returns.[356]

The Federal Circuit Court opinion cited a 1928 Senate Finance Committee Report to legislation that authorized consolidated return regulations, which stated that "many difficult and complicated problems, . . . have arisen in the administration of the provisions permitting the filing of consolidated returns" and that the committee "found it necessary to delegate power to the commissioner to prescribe regulations legislative in character covering them."[357] The Court's opinion also cited a previous decision of the Court of Claims for the proposition, interpreting this legislative history, that section 1502 grants the Secretary "the power to conform the applicable income tax law of the Code to the special, myriad problems resulting from the filing of consolidated income tax returns;" but that section 1502 "does not authorize the Secretary to choose a method that imposes a tax on income that would not otherwise be taxed."[358]

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v. *Commissioner*, 33 B.T.A. 1215 (1936); *Lefcourt Realty Corporation,* 31 B.T.A. 978 (1935); *Helvering* v. *Morgans, Inc.*, 293 U.S. 121 (1934), interpreting the term "taxable year."

[354] Treas. Reg. sec. 1.1502–20(c)(1)(iii).

[355] Treasury Regulation section 1.1502–20, generally imposing certain "loss disallowance" rules on the disposition of subsidiary stock, contained other limitations besides the "duplicated loss" rule that could limit the loss available to the group on a disposition of a subsidiary's stock. Treasury Regulation section 1.1502–20 as a whole was promulgated in connection with regulations issued under section 337(d), principally in connection with the so-called *General Utilities* repeal of 1986 (referring to the case of *General Utilities & Operating Company* v. *Helvering*, 296 U.S. 200 (1935)). Such repeal generally required a liquidating corporation, or a corporation acquired in a stock acquisition treated as a sale of assets, to pay corporate level tax on the excess of the value of its assets over the basis. Treasury regulation section 1.1502–20 principally reflected an attempt to prevent corporations filing consolidated returns from offsetting income with a loss on the sale of subsidiary stock. Such a loss could result from the unique upward adjustment of a subsidiary's stock basis required under the consolidated return regulations for subsidiary income earned in consolidation, an adjustment intended to prevent taxation of both the subsidiary and the parent on the same income or gain. As one example, absent a denial of certain losses on a sale of subsidiary stock, a consolidated group could obtain a loss deduction with respect to subsidiary stock, the basis of which originally reflected the subsidiary's value at the time of the purchase of the stock, and that had then been adjusted upward on recognition of any built-in income or gain of the subsidiary reflected in that value. The regulations also contained the duplicated loss factor addressed by the court in *Rite Aid*. The preamble to the regulations stated: "it is not administratively feasible to differentiate between loss attributable to built-in gain and duplicated loss." T.D. 8364, 1991–2 C.B. 43, 46 (Sept. 13, 1991). The government also argued in the *Rite Aid* case that duplicated loss was a separate concern of the regulations. 255 F.3d at 1360.

[356] For example, the court stated: "The duplicated loss factor . . . addresses a situation that arises from the sale of stock regardless of whether corporations file separate or consolidated returns. With I.R.C. secs. 382 and 383, Congress has addressed this situation by limiting the subsidiary's potential future deduction, not the parent's loss on the sale of stock under I.R.C. sec. 165." 255 F.3d 1357, 1360 (Fed. Cir. 2001).

[357] S. Rep. No. 960, 70th Cong., 1st Sess. 15 (1928). Though not quoted by the court in *Rite Aid,* the same Senate report also indicated that one purpose of the consolidated return authority was to permit treatment of the separate corporations as if they were a single unit, stating "The mere fact that by legal fiction several corporations owned by the same shareholders are separate entities should not obscure the fact that they are in reality one and the same business owned by the same individuals and operated as a unit." S. Rep. No. 960, 70th Cong., 1st Sess. 29 (1928).

[358] *American Standard, Inc.* v. *United States,* 602 F.2d 256, 261 (Ct. Cl. 1979). That case did not involve the question of separate returns as compared to a single return approach. It involved

Continued

The Federal Circuit Court construed these authorities and applied them to invalidate Treas. Reg. Sec. 1.1502–20(c)(1)(iii), stating that:

> The loss realized on the sale of a former subsidiary's assets after the consolidated group sells the subsidiary's stock is not a problem resulting from the filing of consolidated income tax returns. The scenario also arises where a corporate shareholder sells the stock of a non-consolidated subsidiary. The corporate shareholder could realize a loss under I.R.C. sec. 1001, and deduct the loss under I.R.C. sec. 165. The subsidiary could then deduct any losses from a later sale of assets. The duplicated loss factor, therefore, addresses a situation that arises from the sale of stock regardless of whether corporations file separate or consolidated returns. With I.R.C. secs. 382 and 383, Congress has addressed this situation by limiting the subsidiary's potential future deduction, not the parent's loss on the sale of stock under I.R.C. sec. 165.[359]

The Treasury Department has announced that it will not continue to litigate the validity of the duplicated loss provision of the regulations, and has issued interim regulations that permit taxpayers for all years to elect a different treatment, though they may apply the provision for the past if they wish.[360]

REASONS FOR CHANGE

The Committee is concerned that Treasury Department resources might be unnecessarily devoted to defending challenges to consolidated return regulations on the mere assertion by a taxpayer that the result under the consolidated return regulations is different than the result for separate taxpayers. The consolidated return regulations offer many benefits that are not available to separate taxpayers, including generally rules that tax income received by the group once and attempt to avoid a second tax on that same income when stock of a subsidiary is sold.

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the computation of a Western Hemisphere Trade Corporation ("WHTC") deduction under prior law (which deduction would have been computed as a percentage of each WHTC's taxable income if the corporations had filed separate returns), in a case where a consolidated group included several WHTCs as well as other corporations. The question was how to apportion income and losses of the admittedly consolidated WHTCs and how to combine that computation with the rest of the group's consolidated income or losses. The court noted that the new, changed regulations approach varied from the approach taken to a similar problem involving public utilities within a group and previously allowed for WHTCs. The court objected that the allocation method adopted by the regulation allowed non-WHTC losses to reduce WHTC income. However, the court did not disallow a method that would net WHTC income of one WHTC with losses of another WHTC, a result that would not have occurred under separate returns. Nor did the court expressly disallow a different fractional method that would net both income and losses of the WHTCs with those of other corporations in the consolidated group. The court also found that the regulation had been adopted without proper notice.

[359] *Rite Aid,* 255 F.3d at 1360.

[360] See Temp. Reg. Sec. 1.1502–20T(i)(2), Temp. Reg. Sec. 1.337(d)-2T, and Temp. Reg. Sec. 1.1502–35T. The Treasury Department has also indicated its intention to continue to study all the issues that the original loss disallowance regulations addressed (including issues of furthering single entity principles) and possibly issue different regulations (not including the particular approach of Treas. Reg. Sec. 1.1502–20(c)(1)(iii)) on the issues in the future. See Notice 2002–11, 2002–7 I.R.B. 526 (Feb. 19, 2002); T.D. 8984, 67 F.R. 11034 (March 12, 2002); REG–102740–02, 67 F.R. 11070 (March 12, 2002); see also Notice 2002–18, 2002–12 I.R.B. 644 (March 25, 2002); REG–131478–02, 67 F.R. 65060 (October 18, 2002); T.D. 9048, 68 F.R. 12287 (March 14, 2003); and T.D. 9118, REG–153172–03 (March 17, 2004).

EXPLANATION OF PROVISION

The provision confirms that, in exercising its authority under section 1502 to issue consolidated return regulations, the Treasury Department may provide rules treating corporations filing consolidated returns differently from corporations filing separate returns.

Thus, under the statutory authority of section 1502, the Treasury Department is authorized to issue consolidated return regulations utilizing either a single taxpayer or separate taxpayer approach or a combination of the two approaches, as Treasury deems necessary in order that the tax liability of any affiliated group of corporations making a consolidated return, and of each corporation in the group, both during and after the period of affiliation, may be determined and adjusted in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such liability.

*Rite Aid* is thus overruled to the extent it suggests that the Secretary is required to identify a problem created from the filing of consolidated returns in order to issue regulations that change the application of a Code provision. The Secretary may promulgate consolidated return regulations to change the application of a tax code provision to members of a consolidated group, provided that such regulations are necessary to clearly reflect the income tax liability of the group and each corporation in the group, both during and after the period of affiliation.

The provision nevertheless allows the result of the *Rite Aid* case to stand with respect to the type of factual situation presented in the case. That is, the bill provides for the override of the regulatory provision that took the approach of denying a loss on a deconsolidating disposition of stock of a consolidated subsidiary[361] to the extent the subsidiary had net operating losses or built in losses that could be used later outside the group.[362]

Retaining the result in the *Rite Aid* case with respect to the particular regulation section 1.1502–20(c)(1)(iii) as applied to the factual situation of the case does not in any way prevent or invalidate the various approaches Treasury has announced it will apply or that it intends to consider in lieu of the approach of that regulation, including, for example, the denial of a loss on a stock sale if inside losses of a subsidiary may also be used by the consolidated group, and the possible requirement that inside attributes be adjusted when a subsidiary leaves a group.[363]

EFFECTIVE DATE

The provision is effective for all years, whether beginning before, on, or after the date of enactment of the provision. No inference is

[361] Treas. Reg. sec. 1.1502–20(c)(1)(iii).

[362] The provision is not intended to overrule the current Treasury Department regulations, which allow taxpayers in certain circumstances for the past to follow Treasury Regulations Section 1.1502–20(c)(1)(iii), if they choose to do so. Temp. Reg. Sec. 1.1502–20T(i)(2).

[363] See, e.g., Notice 2002–11, 2002–7 I.R.B. 526 (Feb. 19, 2002); Temp. Reg. Sec. 1.337(d)–2T, (T.D. 8984, 67 F.R. 11034 (March 12, 2002) and T.D. 8998, 67 F.R. 37998 (May 31, 2002)); REG–102740–02, 67 F.R. 11070 (March 12, 2002); see also Notice 2002–18, 2002–12 I.R.B. 644 (March 25, 2002); REG–131478–02, 67 F.R. 65060 (October 18, 2002); Temp. Reg. Sec. 1.1502–35T (T.D. 9048, 68 F.R. 12287 (March 14, 2003)); and T.D. 9118, REG–153172–03 (March 17, 2004). In exercising its authority under section 1502, the Secretary is also authorized to prescribe rules that protect the purpose of *General Utilities* repeal using presumptions and other simplifying conventions.

intended that the results following from this provision are not the same as the results under present law.

28. Reform of tax treatment of certain leasing arrangements and limitation on deductions allocable to property used by governments or other tax-exempt entities (secs. 647 through 649 of the bill, secs. 167 and 168 of the Code, and new sec. 470 of the Code)

PRESENT LAW

*Overview of depreciation*

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system ("MACRS"). Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods based on such property's class life. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from 3 to 25 years and are significantly shorter than the property's class life, which is intended to approximate the economic useful life of the property. In addition, the depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.

*Characterization of leases for tax purposes*

In general, a taxpayer is treated as the tax owner and is entitled to depreciate property leased to another party if the taxpayer acquires and retains significant and genuine attributes of a traditional owner of the property, including the benefits and burdens of ownership. No single factor is determinative of whether a lessor will be treated as the owner of the property. Rather, the determination is based on all the facts and circumstances surrounding the leasing transaction.

A sale-leaseback transaction is respected for Federal tax purposes if "there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached."[364]

*Recovery period for tax-exempt use property*

Under present law, "tax-exempt use property" must be depreciated on a straight-line basis over a recovery period equal to the longer of the property's class life or 125 percent of the lease term.[365] For purposes of this rule, "tax-exempt use property" is tangible property that is leased (other than under a short-term

[364] *Frank Lyon Co.* v. *United States,* 435 U.S. 561, 583–84 (1978).

[365] Sec. 168(g)(3)(A). Under present law, section 168(g)(3)(C) states that the recovery period of "qualified technological equipment" is five years.

lease) to a tax-exempt entity.[366] For this purpose, the term "tax-exempt entity" includes Federal, State and local governmental units, charities, and, foreign entities or persons.[367]

In determining the length of the lease term for purposes of the 125-percent calculation, several special rules apply. In addition to the stated term of the lease, the lease term includes options to renew the lease or other periods of time during which the lessee could be obligated to make rent payments or assume a risk of loss related to the leased property.

Tax-exempt use property does not include property that is used by a taxpayer to provide a service to a tax-exempt entity. So long as the relationship between the parties is a bona fide service contract, the taxpayer will be allowed to depreciate the property used in satisfying the contract under normal MACRS rules, rather than the rules applicable to tax-exempt use property.[368] In addition, property is not treated as tax-exempt use property merely by reason of a short-term lease. In general, a short-term lease means any lease the term of which is less than three years and less than the greater of one year or 30 percent of the property's class life.[369]

Also, tax-exempt use property generally does not include qualified technological equipment that meets the exception for leases of high technology equipment to tax-exempt entities with lease terms of five years or less.[370] The recovery period for qualified technological equipment that is treated as tax-exempt use property, but is not subject to the high technology equipment exception, is five years.[371]

The term "qualified technological equipment" is defined as computers and related peripheral equipment, high technology telephone station equipment installed on a customer's premises, and high technology medical equipment.[372] In addition, tax-exempt use property does not include computer software because it is intangible property.

REASONS FOR CHANGE

The special rules applicable to the depreciation of tax-exempt use property were enacted to prevent tax-exempt entities from using leasing arrangements to transfer the tax benefits of accelerated depreciation on property they used to a taxable entity. The Committee is concerned that some taxpayers are attempting to circumvent this policy through the creative use of service contracts with the tax-exempt entities.

More generally, the Committee believes that certain ongoing leasing activity with tax-exempt entities and foreign governments

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

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

[368] Sec. 7701(e) provides that a service contract will not be respected, and instead will be treated as a lease of property, if such contract is properly treated as a lease taking into account all relevant factors. The relevant factors include, among others, the service recipient controls the property, the service recipient is in physical possession of the property, the service provider does not bear significant risk of diminished receipts or increased costs if there is nonperformance, the property is not used to concurrently provide services to other entities, and the contract price does not substantially exceed the rental value of the property.

[369] Sec. 168(h)(1)(C).

[370] Sec. 168(h)(3). However, the exception does not apply if part or all of the qualified technological equipment is financed by a tax-exempt obligation, is sold by the tax-exempt entity (or related party) and leased back to the tax-exempt entity (or related party), or the tax-exempt entity is the United States or any agency or instrumentality of the United States.

[371] Sec. 168(g)(3)(C).

[372] Sec. 168(i)(2).

indicates that the present-law tax rules are not effective in curtailing the ability of a tax-exempt entity to transfer certain tax benefits to a taxable entity. The Committee is concerned about this activity and the continual development of new structures that purport to minimize or neutralize the effect of these rules. In addition, the Committee also is concerned by the increasing use of certain leasing structures involving property purported to be qualified technological equipment. Although the Committee recognizes that leasing plays an important role in ensuring the availability of capital to businesses, it believes that certain transactions of which it recently has become aware do not serve this role. These transactions result in little or no accumulation of capital for financing or refinancing but, instead, essentially involve an accommodation fee paid by a U.S. taxpayer to a tax indifferent party.

In discussing the reasons for the enactment of rules in 1984 that were intended to limit the transfer of tax benefits to taxable entities with respect to property used by tax-exempt entities, Congress at the time stated that: (1) the Federal budget was in no condition to sustain substantial and growing revenue losses by making additional tax benefits (in excess of tax exemption itself) available to tax-exempt entities through leasing transactions; (2) there were concerns about possible problems of accountability of governments to their citizens, and of tax-exempt organizations to their clientele, if substantial amounts of their property came under the control of outside parties solely because the Federal tax system made leasing more favorable than owning; (3) the tax system should not encourage tax-exempt entities to dispose of assets they own or to forego control over the assets they use; (4) there were concerns about waste of Federal revenues because in some cases a substantial portion of the tax savings was retained by lawyers, investment bankers, lessors, and investors and, thus, the Federal revenue loss became more of a gain to financial entities than to tax-exempt entities; (5) providing aid to tax-exempt entities through direct appropriations was more efficient and appropriate than providing such aid through the Code; and (6) popular confidence in the tax system must be sustained by ensuring that the system generally is working correctly and fairly.[373]

The Committee believes that the reasons stated above for the enactment in 1984 of the present-law rules are as important today as they were in 1984. Unfortunately, the present-law rules have not adequately deterred taxpayers from engaging in transactions that attempt to circumvent the rules enacted in 1984. Therefore, the Committee believes that changes to present law are essential to ensure the attainment of the aforementioned Congressional intentions, provided such changes do not inhibit legitimate commercial leasing transactions that involve a significant and genuine transfer of the benefits and burdens of tax ownership between the taxpayer and the tax-exempt lessee.

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[373] See H. Rep. 98–432, Pt. 2, pp. 1140–1141 (1984) and S. Prt. 98–169, Vol. I, pp. 125–127 (1984).

EXPLANATION OF PROVISION

*Overview*

The bill modifies the recovery period of certain property leased to a tax-exempt entity, alters the definition of lease term for all property leased to a tax-exempt entity, expands the short-term lease exception for qualified technological equipment, and establishes rules to limit deductions associated with leases to tax-exempt entities if the leases do not satisfy specified criteria.

*Modify the recovery period of certain property leased to a tax-exempt entity*

The bill modifies the recovery period for qualified technological equipment and computer software leased to a tax-exempt entity[374] to be the longer of the property's assigned class life (or assigned useful life in the case of computer software) or 125 percent of the lease term. The bill does not apply to short-term leases, as defined under present law with a modification described below for short-term leases of qualified technological equipment.

*Modify definition of lease term*

In determining the length of the lease term for purposes of the 125-percent calculation, the bill provides that the lease term includes all service contracts (whether or not treated as a lease under section 7701(e)) and other similar arrangements that follow a lease of property to a tax-exempt entity and that are part of the same transaction (or series of transactions) as the lease.[375]

Under the bill, service contracts and other similar arrangements include arrangements by which services are provided using the property in exchange for fees that provide a source of repayment of the capital investment in the property.[376]

This requirement applies to all leases of property to a tax-exempt entity.

*Expand short-term lease exception for qualified technological equipment*

For purposes of determining whether a lease of qualified technological equipment to a tax-exempt entity satisfies the present-law 5-year short-term lease exception for leases of qualified technological equipment, the bill provides that the term of the lease does not include an option or options of the lessee to renew or extend the lease, provided the rents under the renewal or extension are based upon fair market value determined at the time of the renewal or extension. The aggregate period of such renewals or extensions not included in the lease term under this provision may

[374] The bill defines a tax-exempt entity as under present law. Thus, it includes Federal, State, local, and foreign governmental units, charities, foreign entities or persons.

[375] A service contract involving property that previously was leased to the tax-exempt entity is not part of the same transaction as the preceding leasing arrangement (and, thus, is not included in the lease term of such arrangement) if the service contract was not included in the terms and conditions, or contemplated at the inception, of the preceding leasing arrangement.

[376] For purposes of the bill, a service contract does not include an arrangement for the provision of services if the leased property or substantially similar property is not utilized to provide such services. For example, if at the conclusion of a lease term, a tax-exempt lessee purchases property from the taxpayer and enters into an agreement pursuant to which the taxpayer maintains the property, the maintenance agreement will not be included in the lease term for purposes of the 125-percent computation.

not exceed 24 months. In addition, this provision does not apply to any period following the failure of a tax-exempt lessee to exercise a purchase option if the result of such failure is that the lease renews automatically at fair market value rents.

*Limit deductions for certain leases of property to tax-exempt parties*

The bill also provides that if a taxpayer leases property to a tax-exempt entity, the taxpayer may not claim deductions from the lease transaction in excess of the taxpayer's gross income from the lease for that taxable year. This provision does not apply to certain transactions involving property with respect to which the low-income housing credit or the rehabilitation credit is allowable.

This provision applies to deductions or losses related to a lease to a tax-exempt entity and the leased property.[377] Any disallowed deductions are carried forward and treated as deductions related to the lease in the following taxable year subject to the same limitations. Under rules similar to those applicable to passive activity losses (including the treatment of dispositions of property in which less than all of the gain or loss from the disposition is recognized),[378] a taxpayer generally is permitted to deduct previously disallowed deductions and losses when the taxpayer completely disposes of its interest in the property.

A lease of property to a tax-exempt party is not subject to the deduction limitations of this provision if the lease satisfies all of the following requirements:[379]

(1) Tax-exempt lessee does not monetize its lease obligations

In general, the tax-exempt lessee may not monetize its lease obligations (including any purchase option) in an amount that exceeds 20 percent of the taxpayer's adjusted basis[380] in the leased property at the time the lease is entered into.[381] Specifically, a lease does not satisfy this requirement if the tax-exempt lessee monetizes such excess amount pursuant to an arrangement, set-aside, or expected set-aside, that is to or for the benefit of the taxpayer or any lender, or is to or for the benefit of the tax-exempt lessee, in order to satisfy the lessee's obligations or options under the lease. This determination shall be made at all times during the lease term and shall include the amount of any interest or other income or gain earned on any amount set aside or subject to an arrange-

[377] Deductions related to a lease of tax-exempt use property include any depreciation or amortization expense, maintenance expense, taxes or the cost of acquiring an interest in, or lease of, property. In addition, this provision applies to interest that is properly allocable to tax-exempt use property, including interest on any borrowing by a related person, the proceeds of which were used to acquire an interest in the property, whether or not the borrowing is secured by the leased property or any other property.

[378] See Sec. 469(g).

[379] Even if a transaction satisfies each of the following requirements, the taxpayer will be treated as the owner of the leased property only if the taxpayer acquires and retains significant and genuine attributes of an owner of the property under the present-law tax rules, including the benefits and burdens of ownership.

[380] For purposes of this requirement, the adjusted basis of property acquired by the taxpayer in a like-kind exchange or involuntary conversion to which section 1031 or section 1033 applies is equal to the lesser of (1) the fair market value of the property as of the beginning of the lease term, or (2) the amount that would be the taxpayer's adjusted basis if section 1031 or section 1033 did not apply to such acquisition.

[381] Arrangements to monetize lease obligations include defeasance arrangements, loans by the tax-exempt entity (or an affiliate) to the taxpayer (or an affiliate) or any lender, deposit agreements, letters of credit collateralized with cash or cash equivalents, payment undertaking agreements, prepaid rent (within the meaning of the regulations under section 467), sinking fund arrangements, guaranteed investment contracts, financial guaranty insurance, or any similar arrangements.

ment described in this provision. For purposes of determining whether amounts have been set aside or are expected to be set aside, amounts are treated as set aside or expected to be set aside only if a reasonable person would conclude that the facts and circumstances indicate that such amounts are set aside or expected to be set aside.[382]

The Secretary may provide by regulations that this requirement is satisfied, even if a tax-exempt lessee monetizes its lease obligations or options in an amount that exceeds 20 percent of the taxpayer's adjusted basis in the leased property, in cases in which the creditworthiness of the tax-exempt lessee would not otherwise satisfy the taxpayer's customary underwriting standards. Such credit support would not be permitted to exceed 50 percent of the taxpayer's adjusted basis in the property. In addition, if the lease provides the tax-exempt lessee an option to purchase the property for a fixed purchase price (or for other than the fair market value of the property determined at the time of exercise of the option), such credit support at the time that such option may be exercised would not be permitted to exceed 50 percent of the purchase option price.

Certain lease arrangements that involve circular cash flows or insulation of the taxpayer's equity investment from the risk of loss fail this requirement without regard to the amount in which the tax-exempt lessee monetizes its lease obligations or options. Thus, a lease does not satisfy this requirement if the tax-exempt lessee enters into an arrangement to monetize in any amount its lease obligations or options if such arrangement involves (1) a loan (other than an amount treated as a loan under section 467 with respect to a section 467 rental agreement) from the tax-exempt lessee to the taxpayer or a lender, (2) a deposit that is received, a letter of credit that is issued, or a payment undertaking agreement that is entered into by a lender otherwise involved in the transaction, or (3) in the case of a transaction that involves a lender, any credit support made available to the taxpayer in which any such lender does not have a claim that is senior to the taxpayer.

(2) Taxpayer makes and maintains a substantial equity investment in the leased property

The taxpayer must make and maintain a substantial equity investment in the leased property. For this purpose, a taxpayer generally does not make or maintain a substantial equity investment unless (1) at the time the lease is entered into, the taxpayer initially makes an unconditional at-risk equity investment in the property of at least 20 percent of the taxpayer's adjusted basis[383] in the leased property at that time,[384] (2) the taxpayer maintains such equity investment throughout the lease term, and (3) at all times during the lease term, the fair market value of the property

[382] It is anticipated that the customary and budgeted funding by tax-exempt entities of current obligations under a lease through unrestricted accounts or funds for general working capital needs will not be considered arrangements, set-asides, or expected set-asides under this requirement.

[383] For purposes of this requirement, the adjusted basis of property acquired by the taxpayer in a like-kind exchange or involuntary conversion to which section 1031 or section 1033 applies is equal to the lesser of (1) the fair market value of the property as of the beginning of the lease term, or (2) the amount that would be the taxpayer's adjusted basis if section 1031 or section 1033 did not apply to such acquisition.

[384] The taxpayer's at-risk equity investment shall include only consideration paid, and personal liability incurred, by the taxpayer to acquire the property. Cf. Rev. Proc. 2001–28, 2001–2 C.B. 1156.

at the end of the lease term is reasonably expected to be equal to at least 20 percent of such basis.[385] For this purpose, the fair market value of the property at the end of the lease term is reduced to the extent that a person other than the taxpayer bears a risk of loss in the value of the property.

This requirement does not apply to leases with lease terms of 5 years or less.

(3) Tax-exempt lessee does not bear more than a minimal risk of loss

The tax-exempt lessee generally may not assume or retain more than a minimal risk of loss, other than the obligation to pay rent and insurance premiums, to maintain the property, or other similar conventional obligations of a net lease.[386] For this purpose, a tax-exempt lessee assumes or retains more than a minimal risk of loss if, as a result of obligations assumed or retained by, on behalf of, or pursuant to an agreement with the tax-exempt lessee, the taxpayer is protected from either (1) any portion of the loss that would occur if the fair market value of the leased property were 25 percent less than the leased property's reasonably expected fair market value at the time the lease is terminated, or (2) an aggregate loss that is greater than 50 percent of the loss that would occur if the fair market value of the leased property were zero at lease termination.[387] In addition, the Secretary may provide by regulations that this requirement is not satisfied where the tax-exempt lessee otherwise retains or assumes more than a minimal risk of loss. Such regulations shall be prospective only.

This requirement does not apply to leases with lease terms of 5 years or less.

*Coordination with like-kind exchange and involuntary conversion rules*

Under this provision, neither the like-kind exchange rules (sec. 1031) nor the involuntary conversion rules (sec. 1033) apply if either (1) the exchanged or converted property is tax-exempt use property subject to a lease that was entered into prior to the effective date of this provision and the lease would not have satisfied the requirements of this provision had such requirements been in effect when the lease was entered into, or (2) the replacement property is tax-exempt use property subject to a lease that does not meet the requirements of this provision.

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[385] Cf. Rev. Proc. 2001–28, sec. 4.01(2), 2001–1 C.B. 1156. The fair market value of the property must be determined without regard to inflation or deflation during the lease term and after subtracting the cost of removing the property.

[386] Examples of arrangements by which a tax-exempt lessee might assume or retain a risk of loss include put options, residual value guarantees, residual value insurance, and service contracts. However, leases do not fail to satisfy this requirement solely by reason of lease provisions that require the tax-exempt lessee to pay a contractually stipulated loss value to the taxpayer in the event of an early termination due to a casualty loss, a material default by the tax-exempt lessee (excluding the failure by the tax-exempt lessee to enter into an arrangement described above), or other similar extraordinary events that are not reasonably expected to occur at lease inception.

[387] For purposes of this requirement, residual value protection provided to the taxpayer by a manufacturer or dealer of the leased property is not treated as borne by the tax-exempt lessee if the manufacturer or dealer provides such residual value protection to customers in the ordinary course of its business.

*Other rules*

This provision continues to apply throughout the lease term to property that initially was tax-exempt use property, even if the property ceases to be tax-exempt use property during the lease term.[388] In addition, this provision is applied before the application of the passive activity loss rules under section 469.

This provision does not alter the treatment of any Qualified Motor Vehicle Operating Agreement within the meaning of section 7701(h). In the case of any such agreement, the second and third requirements provided by this provision (relating to taxpayer equity investment and tax-exempt lessee risk of loss, respectively) shall be applied without regard to any terminal rental adjustment clause.

EFFECTIVE DATE

The provision generally is effective for leases entered into after March 12, 2004.[389] However, the provision does not apply to property located in the United States that is subject to a lease with respect to which a formal application (1) was submitted for approval to the Federal Transit Administration (an agency of the Department of Transportation) after June 30, 2003, and before March 13, 2004, (2) is approved by the Federal Transit Administration before January 1, 2005, and (3) includes a description and the fair market value of such property.

The provisions relating to coordination with the like-kind exchange and involuntary conversion rules are effective with respect to property that is exchanged or converted after the date of enactment.

No inference is intended regarding the appropriate present-law tax treatment of transactions entered into prior to the effective date of this provision. In addition, it is intended that this provision shall not be construed as altering or supplanting the present-law tax rules providing that a taxpayer is treated as the owner of leased property only if the taxpayer acquires and retains significant and genuine attributes of an owner of the property, including the benefits and burdens of ownership. This provision also is not intended to affect the scope of any other present-law tax rules or doctrines applicable to purported leasing transactions.

## C. Reduction of Fuel Tax Evasion

### 1. Exemption from certain excise taxes for mobile machinery vehicles (sec. 651 of the bill, and secs. 4053, 4072, 4082, 4483 and 6421 of the Code)

PRESENT LAW

Under present law, the definition of a "highway vehicle" affects the application of the retail tax on heavy vehicles, the heavy vehi-

[388] Conversely, however, a lease of property that is not tax-exempt use property does not become subject to this provision solely by reason of requisition or seizure by the Federal government in national emergency circumstances.

[389] If a lease entered into on or before March 12, 2004, is transferred in a transaction that does not materially alter the terms of such lease, the bill shall not apply to the lease as a result of such transfer.

cle use tax, the tax on tires, and fuel taxes.[390] Section 4051 of the Code provides for a 12-percent retail sales tax on tractors, heavy trucks with a gross vehicle weight ("GVW") over 33,000 pounds, and trailers with a GVW over 26,000 pounds. Section 4071 provides for a tax on highway vehicle tires that weigh more than 40 pounds, with higher rates of tax for heavier tires. Section 4481 provides for an annual use tax on heavy vehicles with a GVW of 55,000 pounds or more, with higher rates of tax on heavier vehicles. All of these excise taxes are paid into the Highway Trust Fund.

Federal excise taxes are also levied on the motor fuels used in highway vehicles. Gasoline is subject to a tax of 18.4 cents per gallon, of which 18.3 cents per gallon is paid into the Highway Trust Fund and 0.1 cent per gallon is paid into the Leaking Underground Storage Tank ("LUST") Trust Fund. Highway diesel fuel is subject to a tax of 24.4 cents per gallon, of which 24.3 cents per gallon is paid into the Highway Trust Fund and 0.1 cent per gallon is paid into the LUST Trust Fund.

The Code does not define a "highway vehicle." For purposes of these taxes, Treasury regulations define a highway vehicle as any self-propelled vehicle or trailer or semitrailer designed to perform a function of transporting a load over the public highway, whether or not also designed to perform other functions. Excluded from the definition of highway vehicle are (1) certain specially designed mobile machinery vehicles for non-transportation functions (the "mobile machinery exception"); (2) certain vehicles specially designed for off-highway transportation for which the special design substantially limits or impairs the use of such vehicle to transport loads over the highway (the "off-highway transportation vehicle" exception); and (3) certain trailers and semi-trailers specially designed to function only as an enclosed stationary shelter for the performance of non-transportation functions off the public highways.[391]

The mobile machinery exception applies if three tests are met: (1) the vehicle consists of a chassis to which jobsite machinery (unrelated to transportation) has been permanently mounted; (2) the chassis has been specially designed to serve only as a mobile carriage and mount for the particular machinery; and (3) by reason of such special design, the chassis could not, without substantial structural modification, be used to transport a load other than the particular machinery. An example of a mobile machinery vehicle is a crane mounted on a truck chassis that meets the forgoing factors.

On June 6, 2002, the Treasury Department put forth proposed regulations that would eliminate the mobile machinery exception.[392] The other exceptions from the definition of highway vehicle would continue to apply with some modifications. Under the proposed regulations, the chassis of a mobile machinery vehicle would be subject to the retail sales tax on heavy vehicles unless the vehicle qualified under the off-highway transportation vehicle exception. Also, under the proposed regulations, mobile machinery vehicles may be subject to the heavy vehicle use tax. In addition, the tax credits, refunds, and exemptions from tax may not be available for the fuel used in these vehicles.

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[390] Secs. 4051, 4071, 4481, 4041 and 4081.
[391] See Treas. Reg. sec. 48.4061–1(d)).
[392] Prop. Treas. Reg. sec. 48.4051–1(a), 67 Fed. Reg. 38913, 38914–38915 (2002).

REASONS FOR CHANGE

The Treasury Department has delayed issuance of final regulations regarding mobile machinery to allow Congressional action on a statutory definition of mobile machinery vehicle. The Highway Trust Fund is supported by taxes related to the use of vehicles on the public highways. The Committee understands that a mobile machinery exemption was created by Treasury regulation because the Treasury Department believed that mobile machinery used the public highways only incidentally to get from one job site to another. However, it has come to the Committee's attention that certain vehicles are taking advantage of the mobile machinery exemption even though they spend a significant amount of time on public highways and, therefore, cause wear and tear to such highways. Because the mobile machinery exemption is based on incidental use of the public highways, the Committee believes it is appropriate to add a use-based test to the design-based test that exists under current regulation. The Committee believes that a use-based test is practical to administer only for purposes of the fuel excise tax.

EXPLANATION OF PROVISION

The provision codifies the present-law mobile machinery exemption for purposes of three taxes: the retail tax on heavy vehicles, the heavy vehicle use tax, and the tax on tires. Thus, if a vehicle can satisfy the three-part test, it will not be treated as a highway vehicle and will be exempt from these taxes.

For purposes of the fuel excise tax, the three-part design test is codified and a use test is added by the provision. Specifically, in addition to the three-part design test, the vehicle must not have traveled more than 7,500 miles over public highways during the owner's taxable year. Refunds of fuel taxes are permitted on an annual basis only. For purposes of this rule, a person's taxable year is his taxable year for income tax purposes.

EFFECTIVE DATE

The provision generally is effective after the date of enactment. As to the fuel taxes, the provision is effective for taxable years beginning after the date of enactment.

2. Taxation of aviation-grade kerosene (sec. 652 of the bill and secs. 4041, 4081, 4082, 4083, 4091, 4092, 4093, 4101, and 6427 of the Code)

PRESENT LAW

*In general*

Aviation fuel is kerosene and any liquid (other than any product taxable under section 4081) that is suitable for use as a fuel in an aircraft.[393] Unlike other fuels that generally are taxed upon removal from a terminal rack,[394] aviation fuel is taxed upon sale of the fuel by a producer or importer.[395] Sales by a registered pro-

[393] Sec. 4093(a).

[394] A rack is a mechanism capable of delivering taxable fuel into a means of transport other than a pipeline or vessel. Treas. Reg. sec. 48.4081–1(b).

[395] Sec. 4091(a)(1).

ducer to another registered producer are exempt from tax, with the result that, as a practical matter, aviation fuel is not taxed until the fuel is used at the airport (or sold to an unregistered person). Use of untaxed aviation fuel by a producer is treated as a taxable sale.[396] The producer or importer is liable for the tax. The rate of tax on aviation fuel is 21.9 cents per gallon.[397]

The tax on aviation fuel is reported by filing Form 720—Quarterly Federal Excise Tax Return. Generally, semi-monthly deposits are required using Form 8109B—Federal Tax Deposit Coupon or by depositing the tax by electronic funds transfer.

*Partial exemptions*

In general, aviation fuel sold for use or used in commercial aviation is taxed at a reduced rate of 4.4 cents per gallon.[398] Commercial aviation means any use of an aircraft in a business of transporting persons or property for compensation or hire by air (unless the use is allocable to any transportation exempt from certain excise taxes).[399]

In order to qualify for the 4.4 cents per gallon rate, the person engaged in commercial aviation must be registered with the Secretary[400] and provide the seller with a written exemption certificate stating the airline's name, address, taxpayer identification number, registration number, and intended use of the fuel. A person that is registered as a buyer of aviation fuel for use in commercial aviation generally is assigned a registration number with a "Y" suffix (a "Y" registrant), which entitles the registrant to purchase aviation fuel at the 4.4 cents per gallon rate.

Large commercial airlines that also are producers of aviation fuel qualify for registration numbers with an "H" suffix. As producers of aviation fuel, "H" registrants may buy aviation fuel tax free pursuant to a full exemption that applies to sales of aviation fuel by a registered producer to a registered producer. If the "H" registrant ultimately uses such untaxed fuel in domestic commercial aviation, the H registrant is liable for the aviation fuel tax at the 4.4 cents per gallon rate.

*Exemptions*

Aviation fuel sold by a producer or importer for use by the buyer in a nontaxable use is exempt from the excise tax on sales of aviation fuel.[401] To qualify for the exemption, the buyer must provide the seller with a written exemption certificate stating the buyer's name, address, taxpayer identification number, registration number (if applicable), and intended use of the fuel.

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[396] Sec. 4091(a)(2).

[397] Sec. 4091(b). This rate includes a 0.1 cent per gallon Leaking Underground Storage Tank ("LUST") Trust Fund tax. The LUST Trust Fund tax is set to expire after March 31, 2005, with the result that on April 1, 2005, the tax rate is scheduled to be 21.8 cents per gallon. Secs. 4091(b)(3)(B) and 4081(d)(3). Beginning on October 1, 2007, the rate of tax is reduced to 4.3 cents per gallon. Sec. 4091(b)(3)(A).

[398] Sec. 4092(b). The 4.4 cent rate includes 0.1 cent per gallon that is attributable to the LUST Trust Fund financing rate. A full exemption, discussed below, applies to aviation fuel that is sold for use in commercial aviation as fuel supplies for vessels or aircraft, which includes use by certain foreign air carriers and for the international flights of domestic carriers. Secs. 4092(a), 4092(b), and 4221(d)(3).

[399] Secs. 4092(b) and 4041(c)(2).

[400] Notice 88–132, sec. III(D). See also, Form 637—Application for Registration (For Certain Excise Tax Activities). A bond may be required as a condition of registration.

[401] Sec. 4092(a).

Nontaxable uses include: (1) use other than as fuel in an aircraft (such as use in heating oil); (2) use on a farm for farming purposes; (3) use in a military aircraft owned by the United States or a foreign country; (4) use in a domestic air carrier engaged in foreign trade or trade between the United States and any of its possessions;[402] (5) use in a foreign air carrier engaged in foreign trade or trade between the United States and any of its possessions (but only if the foreign carrier's country of registration provides similar privileges to United States carriers); (6) exclusive use of a State or local government; (7) sales for export, or shipment to a United States possession; (8) exclusive use by a nonprofit educational organization; (9) use by an aircraft museum exclusively for the procurement, care, or exhibition of aircraft of the type used for combat or transport in World War II, and (10) use as a fuel in a helicopter or a fixed-wing aircraft for purposes of providing transportation with respect to which certain requirements are met.[403]

A producer that is registered with the Secretary may sell aviation fuel tax-free to another registered producer.[404] Producers include refiners, blenders, wholesale distributors of aviation fuel, dealers selling aviation fuel exclusively to producers of aviation fuel, the actual producer of the aviation fuel, and with respect to fuel purchased at a reduced rate, the purchaser of such fuel.

*Refunds and credits*

A claim for refund of taxed aviation fuel held by a registered aviation fuel producer is allowed[405] (without interest) if: (1) the aviation fuel tax was paid by an importer or producer (the "first producer") and the tax has not otherwise been credited or refunded; (2) the aviation fuel was acquired by a registered aviation fuel producer (the "second producer") after the tax was paid; (3) the second producer files a timely refund claim with the proper information; and (4) the first producer and any other person that owns the fuel after its sale by the first producer and before its purchase by the second producer have met certain reporting requirements.[406] Refund claims should contain the volume and type of aviation fuel, the date on which the second producer acquired the fuel, the amount of tax that the first producer paid, a statement by the claimant that the amount of tax was not collected nor included in the sales price of the fuel by the claimant when the fuel was sold to a subsequent purchaser, the name, address, and employer identification number of the first producer, and a copy of any required statement of a subsequent seller (subsequent to the first producer but prior to the second producer) that the second producer received. A claim for refund is filed on Form 8849, Claim for Refund of Excise Taxes, and may not be combined with any other refunds.[407]

A payment is allowable to the ultimate purchaser of taxed aviation fuel if the aviation fuel is used in a nontaxable use.[408] A claim for payment may be made on Form 8849 or on Form 720, Schedule

[402] "Trade" includes the transportation of persons or property for hire. Treas. Reg. sec. 48.4221–4(b)(8).
[403] Secs. 4041(f)(2), 4041(g), 4041(h), 4041(l), and 4092.
[404] Sec. 4092(c).
[405] Sec. 4091(d).
[406] Treas. Reg. sec. 48.4091–3(b).
[407] Treas. Reg. sec. 48.4091–3(d)(1).
[408] Sec. 6427(l)(1).

C. A claim made on Form 720, Schedule C, may be netted against the claimant's excise tax liability.[409] Claims for payment not so taken may be allowable as income tax credits[410] on Form 4136, Credit for Federal Tax Paid on Fuels.

REASONS FOR CHANGE

The Committee believes that the present law rules for taxation of aviation fuel create opportunities for widespread abuse and evasion of fuels excise taxes. In general, aviation fuel is taxed on its sale, whereas other fuel generally is taxed on its removal from a refinery or terminal rack. Because the incidence of tax on aviation fuel is sale and not removal, under present law, aviation fuel may be removed from a refinery or terminal rack tax free if such fuel is intended for use in aviation purposes. The Committee is aware that unscrupulous persons are removing fuel tax free, purportedly for aviation use, but then selling the fuel for highway use, charging their customer the full rate of tax that would be owed on highway fuel, and keeping the amount of the tax.

In order to prevent such fraud, the Committee believes that it is appropriate to conform the tax treatment of all taxable fuels by shifting the incidence of taxation on aviation fuel from the sale of aviation fuel to the removal of such fuel from a refinery or terminal rack. In general, all removals of aviation fuel will be fully taxed at the time of removal, therefore minimizing the cost to the government of the fraudulent diversion of aviation fuel for non-aviation uses. If fuel is later used for an aviation use to which a reduced rate of tax applies, refunds are available. The Committee notes that when the incidence of tax for other fuels (for example, gasoline or diesel) was shifted to the rack, collection of the tax increased significantly indicating that fraud had been occurring.

The provision provides exceptions to the general rule in cases where the opportunities for fraud are insignificant. For example, if fuel is removed from an airport terminal directly into the wing of a commercial aircraft by a hydrant system, it is clear that the fuel will be used in commercial aviation and that the reduced rate of tax for commercial aviation should apply. In addition, if a terminal is located within an secure airport and, except in exigent circumstances, does not fuel highway vehicles, then the Committee believes it is appropriate to permit certain airline refueling vehicles to transport fuel from the terminal rack directly to the wing of an aircraft and have the applicable rate of tax (reduced or otherwise) apply upon removal from the refueling vehicle.

EXPLANATION OF PROVISION

The provision changes the incidence of taxation of aviation fuel from the sale of aviation fuel to the removal of aviation fuel from a refinery or terminal, or the entry into the United States of aviation fuel. Sales of not previously taxed aviation fuel to an unregistered person also are subject to tax.

Under the provision, the full rate of tax—21.9 cents per gallon—is imposed upon removal of aviation fuel from a refinery or terminal (or entry into the United States). Aviation fuel may be re-

[409] Treas. Reg. sec. 40.6302(c)-1(a)(3).
[410] Sec. 34.

moved at a reduced rate—either 4.4 or zero cents per gallon—only if the aviation fuel is: (1) removed directly into the wing of an aircraft (i) that is registered with the Secretary as a buyer of aviation fuel for use in commercial aviation (e.g., a "Y" registrant under current law), (ii) that is a foreign airline entitled to the present law exemption for aviation fuel used in foreign trade, or (iii) for a tax-exempt use; or (2) removed or entered as part of an exempt bulk transfer.[411] An exempt bulk transfer is a removal or entry of aviation fuel transferred in bulk by pipeline or vessel to a terminal or refinery if the person removing or entering the aviation fuel, the operator of such pipeline or vessel, and the operator of such terminal or refinery are registered with the Secretary.

Under a special rule, the provision treats certain refueler trucks, tankers, and tank wagons as a terminal if certain requirements are met. For the special rule to apply, a qualifying truck, tanker, or tank wagon must be loaded with aviation fuel from a terminal: (1) that is located within an airport, and (2) from which no vehicle licensed for highway use is loaded with aviation fuel, except in exigent circumstances identified by the Secretary in regulations. The Committee intends that a terminal is located within an airport if the terminal is located in a secure facility on airport grounds. For example, if an access road runs between a terminal and an airport's runways, and the terminal, like the runways, is physically located on airport grounds and is part of a secure facility, the Committee intends that under the provision the terminal is located within the airport. The Committee intends that an exigent circumstance under which loading a vehicle registered for highway use with fuel would not disqualify a terminal under the special rule would include, for example, the unloading of fuel from bulk storage tanks into highway vehicles in order to repair the storage tanks.

In order to qualify for the special rule, a refueler truck, tanker, or tank wagon must: (1) deliver the aviation fuel directly into the wing of the aircraft at the airport where the terminal is located; (2) have storage tanks, hose, and coupling equipment designed and used for the purposes of fueling aircraft; (3) not be licensed for highway use; and (4) be operated by the terminal operator (who operates the terminal rack from which the fuel is unloaded) or by a person that makes a daily accounting to such terminal operator of each delivery of fuel from such truck, tanker, or tank wagon.[412]

The provision does not change the applicable rates of tax under present law, 21.9 cents per gallon for use in noncommercial aviation, 4.4 cents per gallon for use in commercial aviation, and zero cents per gallon for use by domestic airlines in an international flight, by foreign airlines, or other nontaxable use. The provision imposes liability for the tax on aviation fuel removed from a refinery or terminal directly into the wing of an aircraft for use in commercial aviation on the person receiving the fuel, in which case, such person self-assesses the tax on a return. The provision does not change present-law nontaxable uses of aviation fuel, or change the persons or the qualifications of persons who are entitled to purchase fuel at a reduced rate, except that a producer is not per-

[411] See sec. 4081(a)(1)(B).

[412] The provision requires that if such delivery of information is provided to a terminal operator (or if a terminal operator collects such information), that the terminal operator provide such information to the Secretary.

mitted to purchase aviation fuel at a reduced rate by reason of such persons' status as a producer.

Under the provision, a refund is allowable to the ultimate vendor of aviation fuel if such ultimate vendor purchases fuel tax paid and subsequently sells the fuel to a person qualified to purchase at a reduced rate and who waives the right to a refund. In such a case, the provision permits an ultimate vendor to net refund claims against any excise tax liability of the ultimate vendor, in a manner similar to the present law treatment of ultimate purchaser payment claims.

As under present law, if previously taxed aviation fuel is used for a nontaxable use, the ultimate purchaser may claim a refund for the tax previously paid. If previously taxed aviation fuel is used for a taxable non aircraft use, the fuel is subject to the tax imposed on kerosene (24.4 cents per gallon) and a refund of the previously paid aviation fuel tax is allowed. Claims by the ultimate vendor or the purchaser that are not taken as refund claims may be allowable as income tax credits.

For example, for an airport that is not served by a pipeline, aviation fuel generally is removed from a terminal and transported to an airport storage facility for eventual use at the airport. In such a case, the aviation fuel will be taxed at 21.9 cents per gallon upon removal from the terminal. At the airport, if the fuel is purchased from a vendor by a person registered with the Secretary to use fuel in commercial aviation, the purchaser may buy the fuel at a reduced rate (generally, 4.4 cents per gallon for domestic flights and zero cents per gallon for international flights) and waive the right to a refund. The ultimate vendor generally may claim a refund for the difference between 21.9 cents per gallon of tax paid upon removal and the rate of tax paid to the vendor by the purchaser. To obtain a zero rate upon purchase, a registered domestic airline must certify to the vendor at the time of purchase that the fuel is for use in an international flight; otherwise, the airline must pay the 4.4 cents per gallon rate and file a claim for refund to the Secretary if the fuel is used for international aviation. If a zero rate is paid and the fuel subsequently is used in domestic and not international travel, the domestic airline is liable for tax at 4.4 cents per gallon. A foreign airline eligible under present law to purchase aviation fuel tax-free would continue to purchase such fuel tax-free.

As another example, for an airport that is served by a pipeline, aviation fuel generally is delivered to the wing of an aircraft either by a refueling truck or by a "hydrant" that runs directly from the pipeline to the airplane wing. If a refueling truck that is not licensed for highway use loads fuel from a terminal located within the airport (and the other requirements of the provision for such truck and terminal are met), and delivers the fuel directly to the wing of an aircraft for use in commercial aviation, the aviation fuel is taxed at 4.4 cents per gallon upon delivery to the wing and the person receiving the fuel is liable for the tax, which such person would be able to self-assess on a return.[413] If fuel is loaded into a refueling truck that does not meet the requirements of the provision, then the fuel is treated as removed from the terminal into the

[413] Alternatively, if the aviation fuel in the example is for use in noncommercial aviation, the fuel is taxed at 21.9 cents per gallon upon delivery into the wing. Self-assessment of the tax would not apply in such case.

refueling truck and tax of 21.9 cents per gallon is paid on such removal. The ultimate vendor is entitled to a refund of the difference between 21.9 cents per gallon paid on removal and the rate paid by a commercial airline purchaser (assuming the purchaser waived the refund right). If fuel is removed from a terminal directly to the wing of an aircraft registered to use fuel in commercial aviation by a hydrant or similar device, the person removing the aviation fuel is liable for a tax of 4.4 cents per gallon (or zero in the case of an international flight or qualified foreign airline) and may self-assess such tax on a return.

Under the provision, a floor stocks tax applies to aviation fuel held by a person (if title for such fuel has passed to such person) on October 1, 2004. The tax is equal to the amount of tax that would have been imposed before October 1, 2004, if the provision was in effect at all times before such date, reduced by the tax imposed by section 4091, as in effect on the day before the date of enactment. The Secretary shall determine the time and manner for payment of the tax, including the nonapplication of the tax on de minimis amounts of aviation fuel. Under the provision, 0.1 cents per gallon of such tax is transferred to the LUST Trust Fund. The remainder is transferred to the Airport and Airway Trust Fund.

EFFECTIVE DATE

The provision is effective for aviation fuel removed, entered, or sold after September 30, 2004.

3. Mechanical dye injection and related penalties (sec. 653 of the bill and sec. 4082 and new sec. 6715A of the Code)

PRESENT LAW

*Statutory rules*

Gasoline, diesel fuel and kerosene are generally subject to excise tax upon removal from a refinery or terminal, upon importation into the United States, and upon sale to unregistered persons unless there was a prior taxable removal or importation of such fuels.[414] However, a tax is not imposed upon diesel fuel or kerosene if all of the following are met: (1) the Secretary determines that the fuel is destined for a nontaxable use, (2) the fuel is indelibly dyed in accordance with regulations prescribed by the Secretary,[415] and (3) the fuel meets marking requirements prescribed by the Secretary.[416] A nontaxable use is defined as (1) any use that is exempt from the tax imposed by section 4041(a)(1) other than by reason of a prior imposition of tax, (2) any use in a train, or (3) certain uses

[414] Sec. 4081(a)(1)(A). If such fuel is used for a nontaxable purpose, the purchaser is entitled to a refund of tax paid, or in some cases, an income tax credit. See sec. 6427.

[415] Dyeing is not a requirement, however, for certain fuels under certain conditions, i.e., diesel fuel or kerosene exempted from dyeing in certain States by the EPA under the Clean Air Act, aviation-grade kerosene as determined under regulations prescribed by the Secretary, kerosene received by pipeline or vessel and used by a registered recipient to produce substances (other than gasoline, diesel fuel or special fuels), kerosene removed or entered by a registrant to produce such substances or for resale, and (under regulations) kerosene sold by a registered distributor who sells kerosene exclusively to ultimate vendors that resell it (1) from a pump that is not suitable for fueling any diesel-powered highway vehicle or train, or (2) for blending with heating oil to be used during periods of extreme or unseasonable cold. Sec. 4082(c), (d).

[416] Sec. 4082(a).

in buses for public and school transportation, as described in section 6427(b)(1) (after application of section 6427(b)(3)).[417]

The Secretary is required to prescribe necessary regulations relating to dyeing, including specifically the labeling of retail diesel fuel and kerosene pumps.[418]

A person who sells dyed fuel (or holds dyed fuel for sale) for any use that such person knows (or has reason to know) is a taxable use, or who willfully alters or attempts to alter the dye in any dyed fuel, is subject to a penalty.[419] The penalty also applies to any person who uses dyed fuel for a taxable use (or holds dyed fuel for such a use) and who knows (or has reason to know) that the fuel is dyed.[420] The penalty is the greater of $1,000 per act or $10 per gallon of dyed fuel involved. In determining the amount of the penalty, the $1,000 is increased by the product of $1,000 and the number of prior penalties imposed upon such person (or a related person or predecessor of such person or related person).[421] The penalty may be imposed jointly and severally on any business entity, each officer, employee, or agent of such entity who willfully participated in any act giving rise to such penalty.[422] For purposes of the penalty, the term "dyed fuel" means any dyed diesel fuel or kerosene, whether or not the fuel was dyed pursuant to section 4082.[423]

*Regulations*

The Secretary has prescribed certain regulations under this provision, including regulations that specify the allowable types and concentration of dye, that the person claiming the exemption must be a taxable fuel registrant, that the terminal must be an approved terminal (in the case of a removal from a terminal rack), and the contents of the notice to be posted on diesel fuel and kerosene pumps.[424] However, the regulations do not prescribe the time or method of adding the dye to taxable fuel.[425] Diesel fuel is usually dyed at a terminal rack by either manual dyeing or mechanical injection.

REASONS FOR CHANGE

The Federal government, State governments, and various segments of the petroleum industry have long been concerned with the problem of diesel fuel tax evasion. To address this problem, Congress changed the law to require that untaxed diesel fuel be indelibly dyed. The Committee is concerned, however, that tax can still be evaded through removals at a terminal of undyed fuel that has been designated as dyed.

Manual dyeing is inherently difficult to monitor. It occurs after diesel fuel has been withdrawn from a terminal storage tank, generally requires the work of several people, is imprecise, and does

[417] Sec. 4082(b).
[418] Sec. 4082(e).
[419] Sec. 6715(a).
[420] Sec. 6715(a).
[421] Sec. 6715(b).
[422] Sec. 6715(d).
[423] Sec. 6715(c)(1).
[424] Treas. Reg. secs. 48.4082–1, –2.
[425] In March 2000, the IRS withdrew its Notice of Proposed Rulemaking PS–6–95 (61 F.R. 10490 (1996)) relating to dye injection systems. Announcement 2000–42, 2000–1 C.B. 949. The proposed regulation established standards for mechanical dye injection equipment and required terminal operators to report nonconforming dyeing to the IRS. See also Treas. Reg. sec. 48.4082–1(c), (d).

not automatically create a reliable record. The Committee believes that requiring that untaxed diesel fuel be dyed only by mechanical injection will significantly reduce the opportunities for diesel fuel tax evasion.

The Committee further believes that security of such mechanical dyeing systems will be enhanced by the establishment of standards for making such systems tamper resistant, and by the addition of new penalties for tampering with such mechanical dyeing systems and for failing to maintain the established security standards for such systems. In furtherance of the enforcement of these penalties in the case of business entities, it is appropriate to impose joint and several liability for such penalties upon natural persons who have willfully participated in any act giving rise to these penalties and upon the parent corporation of an affiliated group of which the business entity is a member.

EXPLANATION OF PROVISION

With respect to terminals that offer dyed fuel, the provision eliminates manual dyeing of fuel and requires dyeing by a mechanical system. Not later than 180 days after enactment of this provision, the Secretary of the Treasury is to prescribe regulations establishing standards for tamper resistant mechanical injector dyeing. Such standards shall be reasonable, cost-effective, and establish levels of security commensurate with the applicable facility.

The provision adds an additional set of penalties for violation of the new rules. A penalty, equal to the greater of $25,000 or $10 for each gallon of fuel involved, applies to each act of tampering with a mechanical dye injection system. The person committing the act is also responsible for any unpaid tax on removed undyed fuel. A penalty of $1,000 is imposed for each failure to maintain security for mechanical dye injection systems. An additional penalty of $1,000 is imposed for each day any such violation remains uncorrected after the first day such violation has been or reasonably should have been discovered. For purposes of the daily penalty, a violation may be corrected by shutting down the portion of the system causing the violation. If any of these penalties are imposed on any business entity, each officer, employee, or agent of such entity or other contracting party who willfully participated in any act giving rise to such penalty shall be jointly and severally liable with such entity for such penalty. If such business entity is part of an affiliated group, the parent corporation of such entity shall be jointly and severally liable with such entity for the penalty.

EFFECTIVE DATE

The provision is effective 180 days after the date that the Secretary issues the required regulations. The Secretary must issue such regulations no later than 180 days after enactment.

4. Authority to inspect on-site records (sec. 654 of the bill and sec. 4083 of the Code)

PRESENT LAW

The IRS is authorized to inspect any place where taxable fuel[426] is produced or stored (or may be stored). The inspection is authorized to: (1) examine the equipment used to determine the amount or composition of the taxable fuel and the equipment used to store the fuel; and (2) take and remove samples of taxable fuel. Places of inspection include, but are not limited to, terminals, fuel storage facilities, retail fuel facilities or any designated inspection site.[427]

In conducting the inspection, the IRS may detain any receptacle that contains or may contain any taxable fuel, or detain any vehicle or train to inspect its fuel tanks and storage tanks. The scope of the inspection includes the book and records kept at the place of inspection to determine the excise tax liability under section 4081.[428]

REASONS FOR CHANGE

The Committee believes it is appropriate to expand the authority of the IRS to make on-site inspections of books and records. The Committee believes that such expanded authority will aid in the detection of fuel tax evasion and the enforcement of Federal fuel taxes.

EXPLANATION OF PROVISION

The provision expands the scope of the inspection to include any books, records, or shipping papers pertaining to taxable fuel located in any authorized inspection location.

EFFECTIVE DATE

The provision effective on the date on enactment.

5. Registration of pipeline or vessel operators required for exemption of bulk transfers to registered terminals or refineries (sec. 655 of the bill and sec. 4081 of the Code)

PRESENT LAW

In general, gasoline, diesel fuel, and kerosene ("taxable fuel") are taxed upon removal from a refinery or a terminal.[429] Tax also is imposed on the entry into the United States of any taxable fuel for consumption, use, or warehousing. The tax does not apply to any removal or entry of a taxable fuel transferred in bulk (a "bulk transfer") to a terminal or refinery if both the person removing or entering the taxable fuel and the operator of such terminal or refinery are registered with the Secretary.[430]

Present law does not require that the vessel or pipeline operator that transfers fuel as part of a bulk transfer be registered in order for the transfer to be exempt. For example, a registered refiner

[426] "Taxable fuel" means gasoline, diesel fuel, and kerosene. Sec. 4083(a).
[427] Sec. 4083(c)(1)(A).
[428] Treas. Reg. sec. 48.4083–1(c)(1).
[429] Sec. 4081(a)(1)(A).
[430] Sec. 4081(a)(1)(B). The sale of a taxable fuel to an unregistered person prior to a taxable removal or entry of the fuel is subject to tax. Sec. 4081(a)(1)(A).

may transfer fuel to an unregistered vessel or pipeline operator who in turn transfers fuel to a registered terminal operator. The transfer is exempt despite the intermediate transfer to an unregistered person.

In general, the owner of the fuel is liable for payment of tax with respect to bulk transfers not received at an approved terminal or refinery.[431] The refiner is liable for payment of tax with respect to certain taxable removals from the refinery.[432]

REASONS FOR CHANGE

The Committee is concerned that unregistered pipeline and vessel operators are receiving bulk transfers of taxable fuel, and then diverting the fuel to retailers or end users without the tax ever being paid. The Committee believes that requiring that a pipeline or vessel operator be registered with the IRS in order for a bulk transfer exemption to be valid, in combination with other provisions that impose penalties relating to registration, will help to ensure that transfers of fuel in bulk are delivered as intended to approved refineries and terminals and taxed appropriately.

EXPLANATION OF PROVISION

The provision requires that for a bulk transfer of a taxable fuel to be exempt from tax, any pipeline or vessel operator that is a party to the bulk transfer be registered with the Secretary. Transfer to an unregistered party will subject the transfer to tax.

The Secretary is required to publish periodically a list of all registered persons that are required to register.

EFFECTIVE DATE

The provision is effective on October 1, 2004, except that the Secretary is required to publish the list of registered persons beginning on July 1, 2004.

6. Display of registration and penalties for failure to display registration and to register (secs. 656 and 657 of the bill, secs. 4101, 7232, 7272 and new secs. 6717 and 6718 of the Code)

PRESENT LAW

Blenders, enterers, pipeline operators, position holders, refiners, terminal operators, and vessel operators are required to register with the Secretary with respect to fuels taxes imposed by sections 4041(a)(1) and 4081.[433] A non-assessable penalty for failure to register is $50.[434] A criminal penalty of $5,000, or imprisonment of not more than five years, or both, together with the costs of prosecution also applies to a failure to register and to certain false statements made in connection with a registration application.[435]

REASONS FOR CHANGE

Registration with the Secretary is a critical component of enabling the Secretary to regulate the movement and use of taxable

[431] Treas. Reg. sec. 48.4081–3(e)(2).
[432] Treas. Reg. sec. 48.4081–3(b).
[433] Sec. 4101; Treas. Reg. sec. 48.4101–1(a) and (c)(1).
[434] Sec. 7272(a).
[435] Sec. 7232.

fuels and ensure that the appropriate excise taxes are being collected. The Committee believes that present law penalties are not severe enough to ensure that persons that are required to register in fact register. Accordingly, the Committee believes it is appropriate to increase present law penalties significantly and to add a new assessable penalty for failure to register. In addition, the Committee believes that persons that do business with vessel operators should be able easily to verify whether the vessel operator is registered. Thus, the Committee requires that vessel operators display proof of registration on their vessels and imposes an attendant penalty for failure to display such proof.

EXPLANATION OF PROVISION

The provision requires that every operator of a vessel who is required to register with the Secretary display on each vessel used by the operator to transport fuel, proof of registration through an electronic identification device prescribed by the Secretary. A failure to display such proof of registration results in a penalty of $500 per month per vessel. The amount of the penalty is increased for multiple prior violations. No penalty is imposed upon a showing by the taxpayer of reasonable cause. The provision authorizes amounts equivalent to the penalties received to be appropriated to the Highway Trust Fund.

The provision imposes a new assessable penalty for failure to register of $10,000 for each initial failure, plus $1,000 per day that the failure continues. No penalty is imposed upon a showing by the taxpayer of reasonable cause. In addition, the provision increases the present-law non-assessable penalty for failure to register from $50 to $10,000 and the present law criminal penalty for failure to register from $5,000 to $10,000. The provision authorizes amounts equivalent to any of such penalties received to be appropriated to the Highway Trust Fund.

EFFECTIVE DATE

The provision requiring display of registration is effective on October 1, 2004. The provision relating to penalties is effective for penalties imposed after September 30, 2004.

7. Penalties for failure to report (sec. 657 of the bill and new sec. 6725 of the Code)

PRESENT LAW

A fuel information reporting program, the Excise Summary Terminal Activity Reporting System ("ExSTARS"), requires terminal operators and bulk transport carriers to report monthly on the movement of any liquid product into or out of an approved terminal.[436] Terminal operators file Form 720–TO—Terminal Operator Report, which shows the monthly receipts and disbursements of all liquid products to and from an approved terminal.[437] Bulk transport carriers (barges, vessels, and pipelines) that receive liquid product from an approved terminal or deliver liquid product to

[436] Sec. 4010(d); Treas. Reg. sec. 48.4101–2. The reports are required to be filed by the end of the month following the month to which the report relates.

[437] An approved terminal is a terminal that is operated by a taxable fuel registrant that is a terminal operator. Treas. Reg. sec. 48.4081–1(b).

an approved terminal file Form 720–CS—Carrier Summary Report, which details such receipts and disbursements. In general, the penalty for failure to file a report or a failure to furnish all of the required information in a report is $50 per report.[438]

REASONS FOR CHANGE

The Committee believes that the proper and timely reporting of the disbursements of taxable fuels under the ExSTARs system is essential to the Treasury Department's ability to monitor and enforce the excise fuels taxes. Accordingly, the Committee believes it is appropriate to provide for significant penalties if required information is not provided accurately, completely, and on a timely basis.

EXPLANATION OF PROVISION

The provision imposes a new assessable penalty for failure to file a report or to furnish information required in a report required by the ExSTARS system. The penalty is $10,000 per failure with respect to each vessel or facility (e.g., a terminal or other facility) for which information is required to be furnished. No penalty is imposed upon a showing by the taxpayer of reasonable cause. The provision authorizes amounts equivalent to the penalties received to be appropriated to the Highway Trust Fund.

EFFECTIVE DATE

The provision is effective for penalties imposed after September 30, 2004.

8. Collection from Customs bond where importer not registered (sec. 658 of the bill and new sec. 4104 of the Code)

PRESENT LAW

Typically, gasoline, diesel fuel, and kerosene are transferred by pipeline or barge in large quantities ("bulk") to terminal storage facilities that geographically are located closer to destination retail markets. A fuel is taxed when it "breaks bulk," i.e., when it is removed from the refinery or terminal, typically by truck or rail car, for delivery to a smaller wholesale facility or a retail outlet. The party liable for payment of the taxes is the "position holder," i.e., the person shown on the records of the terminal facility as owning the fuel.

Tax is also imposed on the entry into the United States of any taxable fuel for consumption, use, or warehousing.[439] This tax does not apply to any entry of a taxable fuel transferred in bulk to a terminal or refinery if the person entering the taxable fuel and the operator of such terminal or refinery are registered. The "enterer" is liable for the tax. An enterer generally means the importer of record (under customs law) with respect to the taxable fuel. However, if the importer of record is acting as an agent (a broker for example), the person for whom the agent is acting is the enterer. If there is no importer of record for taxable fuel entered into the United States, the owner of the taxable fuel at the time it is

[438] Sec. 6721(a).
[439] Sec. 4081(a)(1)(A)(iii).

brought into the United States is the enterer. An importer's liability for Customs duties includes a liability for any internal revenue taxes that attach upon the importation of merchandise unless otherwise provided by law or regulation.[440]

As a part of the entry documentation, the importer, consignee, or an authorized agent usually is required to file a bond with Customs. The bond, among other things, guarantees that proper entry summary, with payment of estimated duties and taxes when due, will be made for imported merchandise and that any additional duties and taxes subsequently found to be due will be paid.

As a condition of permitting anyone to be registered with the IRS, under section 4101 of the Code, the Secretary may require that such person give a bond in such sum as the Secretary determines appropriate.

REASONS FOR CHANGE

It is the Committee's understanding that fuel is brought into the United States by unregistered parties and the appropriate tax is not being remitted. Therefore, the Committee believes it is appropriate to allow the Secretary to recover the tax due from the Customs bond.

EXPLANATION OF PROVISION

Under the provision, the importer of record is jointly and severally liable for the tax imposed upon entry of fuel into the United States if, under regulations, any other person that is not registered with the Secretary as a taxable fuel registrant is liable for such tax. If the importer of record is liable for the tax and such tax is not paid on or before the last date prescribed for payment, the Secretary may collect such tax from the Customs bond posted with respect to the importation of the taxable fuel to which the tax relates.

For purposes of determining the jurisdiction of any court of the United States or any agency of the United States, any action by the Secretary to collect the tax from the Customs bond is treated as an action to collect tax from a bond authorized by section 4101 of the Code, not as an action to collect from a bond relating to the importation of merchandise.

EFFECTIVE DATE

The provision is effective for fuel entered after September 30, 2004.

9. Modification of the use tax on heavy highway vehicles (sec. 659 of the bill and secs. 4481, 4483 and 6165 of the Code)

PRESENT LAW

An annual use tax is imposed on heavy highway vehicles, at the rates below.[441]

| | |
|---|---|
| Under 55,000 pounds | No tax. |
| 55,000–75,000 pounds | $100 plus $22 per 1,000 pounds over 55,000. |
| Over 75,000 pounds | $550. |

[440] 19 C.F.R. sec. 141.3 (2004).
[441] Sec. 4481.

The annual use tax is imposed for a taxable period of July 1 through June 30. Generally, the tax is paid by the person in whose name the vehicle is registered. In certain cases, taxpayers are allowed to pay the tax in installments.[442] State governments are required to receive proof of payment of the use tax as a condition of vehicle registration.

Exemptions and reduced rates are provided for certain "transit-type buses," trucks used for fewer than 5,000 miles on public highways (7,500 miles for agricultural vehicles), and logging trucks.[443] Any highway motor vehicle that is issued a base plate by Canada or Mexico and is operated on U.S. highways is subject to the highway use tax whether or not the vehicles are required to be registered in the United States. The tax rate for Canadian and Mexican vehicles is 75 percent of the rate that would otherwise be imposed.[444]

### REASONS FOR CHANGE

The Committee notes that in the case of taxpayers that elect quarterly installment payments, the IRS has no procedure for ensuring that installments subsequent to the first one actually are paid. Thus, it is possible for taxpayers to receive State registrations when only the first quarterly installment is paid with the return. Similarly, it is possible for taxpayers repeatedly to pay the first quarterly installment and continue to receive State registrations because the IRS has no computerized system for checking past compliance when it issues certificates of payment for the current year. In the case of taxpayers owning only one or a few vehicles, it is not cost effective for the IRS to monitor and enforce compliance. Thus, the Committee believes it is appropriate to eliminate the ability of taxpayers to pay the use tax in installments. The Committee also believes that Canadian and Mexican vehicles operating on U.S. highways should be subject to the full amount of use tax, as such vehicles contribute to the wear and tear on U.S. highways.

### EXPLANATION OF PROVISION

The provision eliminates the ability to pay the tax in installments. It also eliminates the reduced rates for Canadian and Mexican vehicles. The provision requires taxpayers with 25 or more vehicles for any taxable period to file their returns electronically. Finally, the provision permits proration of tax for vehicles sold during the taxable period.

### EFFECTIVE DATE

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

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[442] Sec. 6156.
[443] See generally, sec. 4483.
[444] Sec. 4483(f): Treas. Reg. sec. 41.4483–7(a).

10. Modification of ultimate vendor refund claims with respect to farming (sec. 660 of the bill and sec. 6427 of the Code)

PRESENT LAW

In general, the Code provides that, if diesel fuel, kerosene, or aviation fuel on which tax has been imposed is used by any person in a nontaxable use, the Secretary is to refund (without interest) the amount of tax imposed. The refund is made to the ultimate purchaser of the taxed fuel. However, in the case of diesel fuel or kerosene used on a farm for farming purposes or by a State or local government, refund payments are paid to the ultimate, registered vendors ("ultimate vendors") of such fuels.

REASONS FOR CHANGE

The Committee reaffirms its belief that fuel used for farming purposes be exempt from tax, but is concerned that, when large quantities of undyed, or clear, diesel fuel or kerosene are sold for exempt uses and a refund claimed by the "ultimate vendor," there is an increased possibility of diversion of fuel to taxable uses. If there were no expense to the provision and storage of dyed fuel, and if dyed fuel were easily available at all times and locations, the Committee would prefer that only dyed fuel be sold for exempt purposes. However, the Committee recognizes that, to insure sufficient quantities of fuel are available in a timely manner for farming purposes, sometimes clear fuel must be sold to the farmer. In such circumstances, a refund for the tax paid in the price of the clear fuel is appropriate. The Committee believes that the person engaged in farming who purchases the clear fuel is in the best position to certify that the taxed fuel is, in fact, used for farming purposes and therefore it is more appropriate for such a person to claim refunds, rather than the "ultimate vendor" who, as a dealer in fuels, really has no knowledge as to what use the fuel will be put. Notwithstanding this general conclusion, the Committee believes it is appropriate to permit "ultimate vendor" refunds when small amounts of fuel are purchased to ease the filing burden on farmers who purchase small quantities of clear fuel.

EXPLANATION OF PROVISION

In the case of diesel fuel or kerosene used on a farm for farming purposes, the provision limits ultimate vendor claims for refund to sales of such fuel in amounts less than 250 gallons per farmer per claim.

EFFECTIVE DATE

The provision is effective for fuels sold for nontaxable use after the date of enactment.

11. Dedication of revenue from certain penalties to the Highway Trust Fund (sec. 661 of the bill and sec. 9503 of the Code)

PRESENT LAW

Present law does not dedicate to the Highway Trust Fund any penalties assessed and collected by the Secretary.

REASONS FOR CHANGE

The Committee believes it is appropriate to dedicate to the Highway Trust Fund penalties associated with the administration and enforcement of taxes supporting the Highway Trust Fund.

EXPLANATION OF PROVISION

The provision dedicates to the Highway Trust Fund amounts equivalent to the penalties paid under sections 6715 (relating to dyed fuel sold for use or used in taxable use), 6715A (penalty for tampering or failing to maintain security requirements for mechanical dye injection systems), 6717 (penalty for failing to display tax registration on vessels), 6718 (penalty for failing to register under section 4101), 6725 (penalty for failing to report information required by the Secretary), 7232 (penalty for failing to register and false representations of registration status), and 7272 (but only with regard to penalties related to failure to register under section 4101).

EFFECTIVE DATE

The provision is effective October 1, 2004.

12. Taxable fuel refunds for certain ultimate vendors (sec. 662 of the bill and secs. 6416 and 6427 of the Code)

PRESENT LAW

The Code provides that, in the case of gasoline on which tax has been paid and sold to a State or local government, to a nonprofit educational organization, for supplies for vessels or aircraft, for export, or for the production of special fuels, a wholesale distributor that sells the gasoline for such exempt purposes is treated as the person who paid the tax and thereby is the proper claimant for a credit or refund of the tax paid. In the case of undyed diesel fuel or kerosene used on a farm for farming purposes or by a State or local government, a credit or payment is allowable only to the ultimate, registered vendors ("ultimate vendors") of such fuels.

In general, refunds are paid without interest. However, in the case of overpayments of tax on gasoline, diesel fuel, or kerosene that is used to produce a qualified alcohol mixture and for refunds due ultimate vendors of diesel fuel or kerosene used on a farm for farming purposes or by a State or local government, the Secretary is required to pay interest on certain refunds. The Secretary must pay interest on refunds of $200 or more ($100 or more in the case of kerosene) due to the taxpayer arising from sales over any period of a week or more, if the Secretary does not make payment of the refund within 20 days.

REASONS FOR CHANGE

The Committee observes that refund procedures for gasoline differ from those for diesel fuel and kerosene. The Committee believes that simplification of administration can be achieved for both taxpayers and the IRS by providing a more uniform refund procedure applicable to all taxed highway fuels. The Committee further believes that compliance can be increased and administration made less costly by increased use of electronic filing.

The Committee further observes that often State and local governments find it prudent to monitor and pay for fuel purchases by the use of a credit card, fleet buying card, or similar arrangement. In such a case the person extending the credit stands between the vendor of fuel and purchaser of fuel (the State or local government) in an exempt transaction, and the person extending the credit insures payment of the fuel bill thereby paying the amount of any tax owed that is embedded in the price of the fuel. In addition, because the person extending credit to the tax-exempt purchaser has a contractual relationship with the tax-exempt user, the person extending the credit should be best able to establish that the fuel should be sold at a tax-exempt price. The Committee believes that in such a situation it is appropriate to deem the person extending the credit to hold ultimate vendor status, not withstanding that such a person is not actually a vendor of fuel. The Committee observes that the billing service provided by the person extending credit to the tax-exempt purchaser creates a "paper trail" that should facilitate compliance and aid in any necessary audits that the IRS may undertake.

EXPLANATION OF PROVISION

For sales of gasoline to a State or local government for the exclusive use of a State or local government or to a nonprofit educational organization for its exclusive use on which tax has been imposed, the provision conforms the payment of refunds to that procedure established under present law in the case of diesel fuel or kerosene. That is, the ultimate vendor claims for refund.

The provision modifies the payment of interest on refunds. Under the provision, in the case of overpayments of tax on gasoline, diesel fuel, or kerosene that is used to produce a qualified alcohol mixture and for refunds due ultimate vendors of diesel fuel or kerosene used on a farm for farming purposes or by a State or local government, all refunds unpaid after 45 days must be paid with interest. If the taxpayer has filed for his or her refund by electronic means, refunds unpaid after 20 days must be paid with interest.

Lastly, for claims for refund of tax paid on diesel fuel or kerosene sold to State and local governments or for sales of gasoline to a State or local government for the exclusive use of a State or local government or to a nonprofit educational organization for its exclusive use on which tax has been imposed and for which the ultimate purchaser utilized a credit card, the provision deems the person extending the credit to the ultimate purchaser to be the ultimate vendor. That is, the person extending credit via a credit card administers claims for refund, and is responsible for supplying all the appropriate documentation currently required from ultimate vendors.

EFFECTIVE DATE

The provision is effective on October 1, 2004.

## 13. Two party exchanges (sec. 663 of the bill and new sec. 4105 of the Code)

### PRESENT LAW

Most fuel is taxed when it is removed from a registered terminal.[445] The party liable for payment of this tax is the "position holder." The position holder is the person reflected on the records of the terminal operator as holding the inventory position in the fuel.[446]

It is common industry practice for oil companies to serve customers of other oil companies under exchange agreements, e.g., where Company A's terminal is more conveniently located for wholesale or retail customers of Company B. In such cases, the exchange agreement party (Company B in the example) owns the fuel when the motor fuel is removed from the terminal and sold to B's customer.

### REASONS FOR CHANGE

The Committee believes it is appropriate to recognize industry practice under exchange agreements by relieving the original position holder of tax liability for the removal of a taxable fuel from a terminal if certain circumstances are met.

### EXPLANATION OF PROVISION

The provision permits two registered parties to switch position holder status in fuel within a registered terminal (thereby relieving the person originally owning the fuel[447] of tax liability as the position holder) if all of the following occur:

(1) The transaction includes a transfer from the original owner, i.e., the person who holds the original inventory position for taxable fuel in the terminal as reflected in the records of the terminal operator prior to the transaction.

(2) The exchange transaction occurs at the same time as completion of removal across the rack from the terminal by the receiving person or its customer.

(3) The terminal operator in its books and records treats the receiving person as the person that removes the product across a terminal rack for purposes of reporting the transaction to the Internal Revenue Service.

(4) The transaction is the subject of a written contract.

### EFFECTIVE DATE

The provision is effective on the date of enactment.

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[445] A "terminal" is a storage and distribution facility that is supplied by pipeline or vessel, and from which fuel may be removed at a rack. A "rack" is a mechanism capable of delivering taxable fuel into a means of transport other than a pipeline or vessel.

[446] Such person has a contractual agreement with the terminal operator to store and provide services with respect to the fuel. A "terminal operator" is any person who owns, operates, or otherwise controls a terminal. A terminal operator can also be a position holder if that person owns fuel in its terminal.

[447] In the provision, this person is referred to as the "delivering person."

## 14. Simplification of tax on tires (sec. 664 of the bill and sec. 4071 of the Code)

### PRESENT LAW

A graduated excise tax is imposed on the sale by a manufacturer (or importer) of tires designed for use on highway vehicles (sec. 4071). The tire tax rates are as follows:

| *Tire weight* | *Tax rate* |
|---|---|
| Not more than 40 lbs. | No tax. |
| More than 40 lbs., but not more than 70 lbs. | 15 cents/lb. in excess of 40 lbs |
| More than 70 lbs., but not more than 90 lbs. | $4.50 plus 30 cents/lb. in excess of 70 lbs. |
| More than 90 lbs. | $10.50 plus 50 cents/lb. in excess of 90 lbs. |

No tax is imposed on the recapping of a tire that previously has been subject to tax. Tires of extruded tiring with internal wire fastening also are exempt.

The tax expires after September 30, 2005.

### REASONS FOR CHANGE

Under present law, the tire excise tax is based on the weight of each tire. This forces tire manufacturers to weigh sample batches of every type of tire made and collect the tax based on that weight. This regime also makes it difficult for the IRS to measure and enforce compliance with the tax, as the IRS likewise must weigh sample batches of tires to ensure compliance. The Committee believes significant administrative simplification for both tire manufacturers and the IRS will be achieved if the tax were based on the weight carrying capacity of the tire, rather than the weight of the tire, because Department of Transportation requires the load rating to be stamped on the side of highway tires. Thus, both the manufacturer and the IRS will know immediately whether a tire is taxable and how much tax should be paid.

### EXPLANATION OF PROVISION

The provision modifies the excise tax applicable to tires. The provision replaces the present-law tax rates based on the weight of the tire with a tax rate based on the load capacity of the tire. In general, the tax is 9.4 cents for each 10 pounds of tire load capacity in excess of 3,500 pounds. In the case of a biasply tire, the tax rate is 4.7 cents for each 10 pounds of tire load capacity in excess of 3,500 pounds.

The provision modifies the definition of tires for use on highway vehicles to include any tire marked for highway use pursuant to certain regulations promulgated by the Secretary of Transportation. The provision also exempts from tax any tire sold for the exclusive use of the United States Department of Defense or the United States Coast Guard.

Tire load capacity is the maximum load rating labeled on the tire pursuant to regulations promulgated by the Secretary of Transportation. A biasply tire is any tire manufactured primarily for use on piggyback trailers.

EFFECTIVE DATE

The provision is effective for sales in calendar years beginning more than 30 days after the date of enactment.

## D. NONQUALIFIED DEFERRED COMPENSATION PLANS

### 1. Treatment of nonqualified deferred compensation plans (sec. 671 of the bill and new sec. 409A and sec. 6051 of the Code)

PRESENT LAW

*In general*

The determination of when amounts deferred under a nonqualified deferred compensation arrangement are includible in the gross income of the individual earning the compensation depends on the facts and circumstances of the arrangement. A variety of tax principles and Code provisions may be relevant in making this determination, including the doctrine of constructive receipt, the economic benefit doctrine,[448] the provisions of section 83 relating generally to transfers of property in connection with the performance of services, and provisions relating specifically to nonexempt employee trusts (sec. 402(b)) and nonqualified annuities (sec. 403(c)).

In general, the time for income inclusion of nonqualified deferred compensation depends on whether the arrangement is unfunded or funded. If the arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received. If the arrangement is funded, then income is includible for the year in which the individual's rights are transferable or not subject to a substantial risk of forfeiture.

Nonqualified deferred compensation is generally subject to social security and Medicare taxes when the compensation is earned (i.e., when services are performed), unless the nonqualified deferred compensation is subject to a substantial risk of forfeiture. If nonqualified deferred compensation is subject to a substantial risk of forfeiture, it is subject to social security and Medicare tax when the risk of forfeiture is removed (i.e., when the right to the nonqualified deferred compensation vests). Amounts deferred under a nonaccount balance plan that are not reasonably ascertainable are not required to be taken into account as wages subject to social security and Medicare taxes until the first date that such amounts are reasonably ascertainable. Social security and Medicare tax treatment is not affected by whether the arrangement is funded or unfunded, which is relevant in determining when amounts are includible in income (and subject to income tax withholding).

In general, an arrangement is considered funded if there has been a transfer of property under section 83. Under that section, a transfer of property occurs when a person acquires a beneficial ownership interest in such property. The term "property" is defined very broadly for purposes of section 83.[449] Property includes real and personal property other than money or an unfunded and unsecured promise to pay money in the future. Property also includes

[448] See, e.g., *Sproull* v. *Commissioner,* 16 T.C. 244 (1951), aff'd per curiam, 194 F.2d 541 (6th Cir. 1952); Rev. Rul. 60–31, 1960–1 C.B. 174.

[449] Treas. Reg. sec. 1.83–3(e). This definition in part reflects previous IRS rulings on nonqualified deferred compensation.

a beneficial interest in assets (including money) that are transferred or set aside from claims of the creditors of the transferor, for example, in a trust or escrow account. Accordingly, if, in connection with the performance of services, vested contributions are made to a trust on an individual's behalf and the trust assets may be used solely to provide future payments to the individual, the payment of the contributions to the trust constitutes a transfer of property to the individual that is taxable under section 83. On the other hand, deferred amounts are generally not includible in income if nonqualified deferred compensation is payable from general corporate funds that are subject to the claims of general creditors, as such amounts are treated as unfunded and unsecured promises to pay money or property in the future.

As discussed above, if the arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received under section 451.[450] Income is constructively received when it is credited to an individual's account, set apart, or otherwise made available so that it may be drawn on at any time. Income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. A requirement to relinquish a valuable right in order to make withdrawals is generally treated as a substantial limitation or restriction.

*Rabbi trusts*

Arrangements have developed in an effort to provide employees with security for nonqualified deferred compensation, while still allowing deferral of income inclusion. A "rabbi trust" is a trust or other fund established by the employer to hold assets from which nonqualified deferred compensation payments will be made. The trust or fund is generally irrevocable and does not permit the employer to use the assets for purposes other than to provide nonqualified deferred compensation, except that the terms of the trust or fund provide that the assets are subject to the claims of the employer's creditors in the case of insolvency or bankruptcy.

As discussed above, for purposes of section 83, property includes a beneficial interest in assets set aside from the claims of creditors, such as in a trust or fund, but does not include an unfunded and unsecured promise to pay money in the future. In the case of a rabbi trust, terms providing that the assets are subject to the claims of creditors of the employer in the case of insolvency or bankruptcy have been the basis for the conclusion that the creation of a rabbi trust does not cause the related nonqualified deferred compensation arrangement to be funded for income tax purposes.[451] As a result, no amount is included in income by reason of the rabbi trust; generally income inclusion occurs as payments are made from the trust.

The IRS has issued guidance setting forth model rabbi trust provisions.[452] Revenue Procedure 92–64 provides a safe harbor for taxpayers who adopt and maintain grantor trusts in connection with

[450] Treas. Reg. secs. 1.451–1 and 1.451–2.

[451] This conclusion was first provided in a 1980 private ruling issued by the IRS with respect to an arrangement covering a rabbi; hence the popular name "rabbi trust." Priv. Ltr. Rul. 8113107 (Dec. 31, 1980).

[452] Rev. Proc. 92–64, 1992–2 C.B. 422, modified in part by Notice 2000–56, 2000–2 C.B. 393.

unfunded deferred compensation arrangements. The model trust language requires that the trust provide that all assets of the trust are subject to the claims of the general creditors of the company in the event of the company's insolvency or bankruptcy.

Since the concept of rabbi trusts was developed, arrangements have developed which attempt to protect the assets from creditors despite the terms of the trust. Arrangements also have developed which attempt to allow deferred amounts to be available to individuals, while still purporting to meet the safe harbor requirements set forth by the IRS.

REASONS FOR CHANGE

The Committee is aware of the popular use of deferred compensation arrangements by executives to defer current taxation of substantial amounts of income. The Committee believes that many nonqualified deferred compensation arrangements have developed which allow improper deferral of income. Executives often use arrangements that allow deferral of income, but also provide security of future payment and control over amounts deferred. For example, nonqualified deferred compensation arrangements often contain provisions that allow participants to receive distributions upon request, subject to forfeiture of a minimal amount (i.e., a "haircut" provision).

The Committee is aware that since the concept of a rabbi trust was developed, techniques have been used that attempt to protect the assets from creditors despite the terms of the trust. For example, the trust or fund may be located in a foreign jurisdiction, making it difficult or impossible for creditors to reach the assets.

While the general tax principles governing deferred compensation are well established, the determination whether a particular arrangement effectively allows deferral of income is generally made on a facts and circumstances basis. There is limited specific guidance with respect to common deferral arrangements. The Committee believes that it is appropriate to provide specific rules regarding whether deferral of income inclusion should be permitted.

The Committee believes that certain arrangements that allow participants inappropriate levels of control or access to amounts deferred should not result in deferral of income inclusion. The Committee also believes that certain arrangements, such as offshore trusts, which effectively protect assets from creditors, should be treated as funded and not result in deferral of income inclusion.[453]

EXPLANATION OF PROVISION

Under the provision, all amounts deferred under a nonqualified deferred compensation plan[454] for all taxable years are currently includible in gross income to the extent not subject to a substantial

[453] The staff of the Joint Committee on Taxation made recommendations similar to the new provision in the report on their investigation of Enron Corporation, which detailed how executives deferred millions of dollars in Federal income taxes through nonqualified deferred compensation arrangements. See Joint Committee on Taxation, Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations (JCS–3–03), February 2003.

[454] A plan includes an agreement or arrangement, including an agreement or arrangement that includes one person.

risk of forfeiture[455] and not previously included in gross income, unless certain requirements are satisfied. If the requirements of the provision are not satisfied, in addition to current income inclusion, interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture. Actual or notional earnings on amounts deferred are also subject to the provision.

Under the provision, distributions from a nonqualified deferred compensation plan may be allowed only upon separation from service (as determined by the Secretary), death, a specified time (or pursuant to a fixed schedule), change in control in a corporation (to the extent provided by the Secretary), occurrence of an unforeseeable emergency, or if the participant becomes disabled. A nonqualified deferred compensation plan may not allow distributions other than upon the permissible distribution events and may not permit acceleration of a distribution, except as provided in regulations by the Secretary.

In the case of a specified employee, distributions upon separation from service may not be made earlier than six months after the date of the separation from service. Specified employees are key employees[456] of publicly-traded corporations.

Amounts payable at a specified time or pursuant to a fixed schedule must be specified under the plan at the time of deferral. Amounts payable upon the occurrence of an event are not treated as amounts payable at a specified time. For example, amounts payable when an individual attains age 65 are payable at a specified time, while amounts payable when an individual's child begins college are payable upon the occurrence of an event.

Distributions upon a change in the ownership or effective control of a corporation, or in the ownership of a substantial portion of the assets of a corporation, may only be made to the extent provided by the Secretary. It is intended that the Secretary use a similar, but more restrictive, definition of change in control as is used for purposes of the golden parachute provisions of section 280G consistent with the purposes of the provision. The provision requires the Secretary to issue guidance defining change of control within 90 days after the date of enactment.

An unforeseeable emergency is defined as a severe financial hardship to the participant resulting from a sudden and unexpected illness or accident of the participant, the participant's spouse, or a dependent (as defined in 152(a)) of the participant; loss of the participant's property due to casualty; or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant. The amount of the distribution must be limited to the amount needed to satisfy the emergency plus taxes reasonably anticipated as a result of the distribution. Distributions may not be allowed to the extent that the hard-

[455] As under section 83, the rights of a person to compensation are subject to a substantial risk of forfeiture if the person's rights to such compensation are conditioned upon the performance of substantial services by any individual.

[456] Key employees are defined in section 416(i) and generally include officers having annual compensation greater than $130,000 (adjusted for inflation and limited to 50 employees), five percent owners, and one percent owners having annual compensation from the employer greater than $150,000.

ship may be relieved through reimbursement or compensation by insurance or otherwise, or by liquidation of the participant's assets (to the extent such liquidation would not itself cause a severe financial hardship).

A participant is considered disabled if he or she (i) is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months; or (ii) is, by reason on any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, receiving income replacement benefits for a period of not less than three months under an accident and health plan covering employees of the participant's employer.

As previously discussed, except as provided in regulations by the Secretary, no accelerations of distributions may be allowed. For example, changes in the form of a distribution from an annuity to a lump sum are not permitted. The provision provides the Secretary authority to provide, through regulations, limited exceptions to the general rule that no accelerations can be permitted. It is intended that exceptions be provided only in limited cases where the accelerated distribution is required for reasons beyond the control of the participant. For example, it is anticipated that an exception could be provided in order to comply with Federal conflict of interest requirements or court-approved settlements.

The provision requires that the plan must provide that compensation for services performed during a taxable year may be deferred at the participant's election only if the election to defer is made no later than the close of the preceding taxable year, or at such other time as provided in Treasury regulations. For example, it is expected that Treasury regulations provide that, in appropriate circumstances, elections to defer incentive bonuses earned over a period of several years may be made after the beginning of the service period, as long as such elections may in no event be made later than 12 months before the earliest date on which such incentive bonus is initially payable. The Secretary may consider other factors in determining the appropriate election period, such as when the amount of the bonus payment is determinable. It is expected that Treasury regulations will not permit any election to defer any bonus or other compensation if the timing of such election would be inconsistent with the purposes of the provision. Under the provision, in the first year that an employee becomes eligible for participation in a nonqualified deferred compensation plan, the election may be made within 30 days after the date that the employee is initially eligible.

The time and form of distributions must be specified at the time of initial deferral. A plan could specify the time and form of payments that are to be made as a result of a distribution event (e.g., a plan could specify that payments upon separation of service will be paid in lump sum within 30 days of separation from service) or could allow participants to elect the time and form of payment at the time of the initial deferral election. If a plan allows participants to elect the time and form of payment, such election is subject to the rules regarding initial deferral elections under the provision.

Under the provision, a plan may allow changes in the time and form of distributions subject to certain requirements. A nonqualified deferred compensation plan may allow a subsequent election to delay the timing or form of distributions only if: (1) the plan requires that such election cannot be effective for at least 12 months after the date on which the election is made; (2) except in the case of elections relating to distributions on account of death, disability or unforeseeable emergency, the plan requires that the additional deferral with respect to which such election is made is for a period of not less than five years from the date such payment would otherwise have been made; and (3) the plan requires that an election related to a distribution to be made upon a specified time may not be made less than 12 months prior to the date of the first scheduled payment. It is expected that in limited cases, the Secretary shall issue guidance, consistent with the purposes of the provision, regarding to what extent elections to change a stream of payments are permissible.

If impermissible distributions or elections are made, or if the nonqualified deferred compensation plan allows impermissible distributions or elections, all amounts deferred under the plan (including amounts deferred in prior years) are currently includible in income to the extent not subject to a substantial risk of forfeiture and not previously included in income. In addition, interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture.

Under the provision, in the case of assets set aside (directly or indirectly) in a trust (or other arrangement determined by the Secretary) for purposes of paying nonqualified deferred compensation, such assets are treated as property transferred in connection with the performance of services under section 83 (whether or not such assets are available to satisfy the claims of general creditors) at the time set aside if such assets are located outside of the United States or at the time transferred if such assets are subsequently transferred outside of the United States. Any subsequent increases in the value of, or any earnings with respect to, such assets are treated as additional transfers of property. Interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the amounts been includible in income for the taxable year in which first deferred or, if later, the first taxable year not subject to a substantial risk of forfeiture. It is expected that the Secretary shall provide rules for identifying the deferrals to which assets set aside are attributable, for situations in which assets equal to less than the full amount of deferrals are set aside. The Secretary has authority to exempt arrangements from the provision if the arrangements do not result in an improper deferral of U.S. tax and will not result in assets being effectively beyond the reach of creditors.

Under the provision, a transfer of property in connection with the performance of services under section 83 also occurs with respect to compensation deferred under a nonqualified deferred compensation plan if the plan provides that upon a change in the employer's financial health, assets will be restricted to the payment of nonqualified deferred compensation. The transfer of property oc-

curs as of the earlier of when the assets are so restricted or when the plan provides that assets will be restricted. It is intended that the transfer of property occurs to the extent that assets are restricted or will be restricted with respect to such compensation. For example, in the case of a plan that provides that upon a change in the employer's financial health, a trust will become funded to the extent of all deferrals, all amounts deferred under the plan are treated as property transferred under section 83. If a plan provides that deferrals of certain individuals will be funded upon a change in financial health, the transfer of property would occur with respect to compensation deferred by such individuals. Any subsequent increases in the value of, or any earnings with respect to, such assets are treated as additional transfers of property. Interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the amounts been includible in income for the taxable year in which first deferred or, if later, the first taxable year not subject to a substantial risk of forfeiture.

A nonqualified deferred compensation plan is any plan that provides for the deferral of compensation other than a qualified employer plan or any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. A qualified employer plan means a qualified retirement plan, tax-deferred annuity, simplified employee pension, and SIMPLE.[457] A governmental eligible deferred compensation plan (sec. 457) is also a qualified employer plan under the provision.[458] Plans subject to section 457, other than governmental eligible deferred compensation plans, are subject to both the requirements of section 457 and the provision. For example, in addition to the requirements of the provision, an eligible deferred compensation plan of a tax-exempt employer would still be required to meet the applicable dollar limits under section 457.

Interest imposed under the provision is treated as interest on an underpayment of tax. Income (whether actual or notional) attributable to nonqualified deferred compensation is treated as additional deferred compensation and is subject to the provision. The provision is not intended to prevent the inclusion of amounts in gross income under any provision or rule of law earlier than the time provided in the provision. Any amount included in gross income under the provision shall not be required to be included in gross income under any provision of law later than the time provided in the provision. The provision does not affect the rules regarding the timing of an employer's deduction for nonqualified deferred compensation.

The provision requires annual reporting to the Internal Revenue Service of amounts deferred. Such amounts are required to be reported on an individual's Form W–2 for the year deferred even if the amount is not currently includible in income for that taxable year. Under the provision, the Secretary is authorized, through regulations, to establish a minimum amount of deferrals below which the reporting requirement does not apply. The Secretary may also provide that the reporting requirement does not apply with respect

[457] A qualified employer plan also includes a section 501(c)(18) trust.

[458] A governmental deferred compensation plan that is not an eligible deferred compensation plan is not a qualified employer plan.

to amounts of deferrals that are not reasonably ascertainable. It is intended that the exception for amounts not reasonable ascertainable only apply to nonaccount balance plans and that amounts be required to be reported when they first become reasonably ascertainable.[459]

The provision provides the Secretary authority to prescribe regulations as are necessary to carry out the purposes of provision, including regulations: (1) providing for the determination of amounts of deferral in the case of defined benefit plans; (2) relating to changes in the ownership and control of a corporation or assets of a corporation; (3) exempting from the provisions providing for transfers of property arrangements that will not result in an improper deferral of U.S. tax and will not result in assets being effectively beyond the reach of creditors; (4) defining financial health; and (5) disregarding a substantial risk of forfeiture.

It is intended that substantial risk of forfeitures may not be used to manipulate the timing of income inclusion. It is intended that substantial risks of forfeiture should be disregarded in cases in which they are illusory or are used inconsistent with the purposes of the provision. For example, if an executive is effectively able to control the acceleration of the lapse of a substantial risk of forfeiture, such risk of forfeiture should be disregarded and income inclusion should not be postponed on account of such restriction.

EFFECTIVE DATE

The provision is effective for amounts deferred after June 3, 2004. The provision does not apply to amounts deferred after June 3, 2004, and before January 1, 2005, pursuant to an irrevocable election or binding arrangement made before June 4, 2004. Earnings on amounts deferred before the effective date are subject to the provision to the extent that such amounts deferred are subject to the provision.

It is intended that amounts further deferred under a subsequent election with respect to amounts originally deferred before June 4, 2004, are subject to the requirements of the provision.

No later than 90 days after the date of enactment, the Secretary shall issue guidance providing a limited period of time during which an individual participating in a nonqualified deferred compensation plan adopted before June 4, 2004, may, without violating the requirements of the provision, terminate participation or cancel an outstanding deferral election with regard to amounts earned after June 3, 2004, if such amounts are includible in income as earned.

## E. Other Revenue Provisions

### 1. Qualified tax collection contracts (sec. 681 of the bill and new sec. 6306 of the Code)

PRESENT LAW

In fiscal years 1996 and 1997, the Congress earmarked $13 million for IRS to test the use of private debt collection companies. There were several constraints on this pilot project. First, because

[459] It is intended that the exception be similar to that under Treas. Reg. sec. 31.3121(v)(2)–1(e)(4).

both IRS and OMB considered the collection of taxes to be an inherently governmental function, only government employees were permitted to collect the taxes.[460] The private debt collection companies were utilized to assist the IRS in locating and contacting taxpayers, reminding them of their outstanding tax liability, and suggesting payment options. If the taxpayer agreed at that point to make a payment, the taxpayer was transferred from the private debt collection company to the IRS. Second, the private debt collection companies were paid a flat fee for services rendered; the amount that was ultimately collected by the IRS was not taken into account in the payment mechanism.

The pilot program was discontinued because of disappointing results. GAO reported[461] that IRS collected $3.1 million attributable to the private debt collection company efforts; expenses were also $3.1 million. In addition, there were lost opportunity costs of $17 million to the IRS because collection personnel were diverted from their usual collection responsibilities to work on the pilot. The pilot program results were disappointing because "IRS' efforts to design and implement the private debt collection pilot program were hindered by limitations that affected the program's results." The limitations included the scope of work permitted to the private debt collection companies, the number and type of cases referred to the private debt collection companies, and the ability of IRS' computer systems to identify, select, and transmit collection cases to the private debt collectors.

The IRS has in the last several years expressed renewed interest in the possible use of private debt collection companies; for example, IRS recently revised its extensive Request for Information concerning its possible use of private debt collection companies.[462] GAO recently reviewed IRS' planning and preparation for the use of private debt collection companies.[463] GAO identified five broad factors critical to the success of using private debt collection companies to collect taxes. GAO concluded: "If Congress does authorize PCA[464] use, IRS's planning and preparations to address the critical success factors for PCA contracting provide greater assurance that the PCA program is headed in the right direction to meet its goals and achieve desired results. Nevertheless, much work and many challenges remain in addressing the critical success factors and helping to maximize the likelihood that a PCA program would be successful."[465]

In general, Federal agencies are permitted to enter into contracts with private debt collection companies for collection services to recover indebtedness owed to the United States.[466] That provision does not apply to the collection of debts under the Internal Revenue Code.[467]

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[460] Sec. 7801(a).
[461] GAO/GGD–97–129R Issues Affecting IRS' Collection Pilot (July 18, 1997).
[462] TIRNO–03–H–0001 (February 14, 2003), at www.procurement.irs.treas.gov. The basic request for information is 104 pages, and there are 16 additional attachments.
[463] GAO–04–492 Tax Debt Collection: IRS Is Addressing Critical Success Factors for Contracting Out but Will Need to Study the Best Use of Resources (May 2004).
[464] Private collection agencies.
[465] Page 19 of the May 2004 GAO report.
[466] 31 U.S.C. sec. 3718.
[467] 31 U.S.C. sec. 3718(f).

The President's fiscal year 2004 and 2005 budget proposals proposed the use of private debt collection companies to collect Federal tax debts.

REASONS FOR CHANGE

The Committee believes that the use of private debt collection agencies will help facilitate the collection of taxes that are owed to the Government. The Committee also believes that the safeguards it has incorporated will protect taxpayers' rights and privacy.

EXPLANATION OF PROVISION

The bill permits the IRS to use private debt collection companies to locate and contact taxpayers owing outstanding tax liabilities of any type[468] and to arrange payment of those taxes by the taxpayers. There must be an assessment pursuant to section 6201 in order for there to be an outstanding tax liability. An assessment is the formal recording of the taxpayer's tax liability that fixes the amount payable. An assessment must be made before the IRS is permitted to commence enforcement actions to collect the amount payable. In general, an assessment is made at the conclusion of all examination and appeals processes within the IRS.[469]

Several steps are involved in the deployment of private debt collection companies. First, the private debt collection company contacts the taxpayer by letter.[470] If the taxpayer's last known address is incorrect, the private debt collection company searches for the correct address. Second, the private debt collection company telephones the taxpayer to request full payment.[471] If the taxpayer cannot pay in full immediately, the private debt collection company offers the taxpayer an installment agreement providing for full payment of the taxes over a period of as long as five years. If the taxpayer is unable to pay the outstanding tax liability in full over a five-year period, the private debt collection company obtains financial information from the taxpayer and will provide this information to the IRS for further processing and action by the IRS.

The bill specifies several procedural conditions under which the provision would operate. First, provisions of the Fair Debt Collection Practices Act apply to the private debt collection company. Second, taxpayer protections that are statutorily applicable to the IRS are also made statutorily applicable to the private sector debt collection companies. In addition, taxpayer protections that are statutorily applicable to IRS employees are also made statutorily applicable to employees of private sector debt collection companies.

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[468] The provision generally applies to any type of tax imposed under the Internal Revenue Code. It is anticipated that the focus in implementing the provision will be: (a) taxpayers who have filed a return showing a balance due but who have failed to pay that balance in full; and (b) taxpayers who have been assessed additional tax by the IRS and who have made several voluntary payments toward satisfying their obligation but have not paid in full.

[469] An amount of tax reported as due on the taxpayer's tax return is considered to be self-assessed. If the IRS determines that the assessment or collection of tax will be jeopardized by delay, it has the authority to assess the amount immediately (sec. 6861), subject to several procedural safeguards.

[470] Several portions of the provision require that the IRS disclose confidential taxpayer information to the private debt collection company. Section 6103(n) permits disclosure for "the providing of other services ... for purposes of tax administration." Accordingly, no amendment to section 6103 is necessary to implement the provision. It is intended, however, that the IRS vigorously protect the privacy of confidential taxpayer information by disclosing the least amount of information possible to contractors consistent with the effective operation of the provision.

[471] The private debt collection company is not permitted to accept payment directly. Payments are required to be processed by IRS employees.

Third, subcontractors are prohibited from having contact with taxpayers, providing quality assurance services, and composing debt collection notices; any other service provided by a subcontractor must receive prior approval from the IRS. In addition, the Committee intends that the IRS require the private sector debt collection companies to inform every taxpayer they contact of the availability of assistance from the Taxpayer Advocate.

The bill creates a revolving fund from the amounts collected by the private debt collection companies. The private debt collection companies will be paid out of this fund. The bill prohibits the payment of fees for all services in excess of 25 percent of the amount collected under a tax collection contract.[472]

EFFECTIVE DATE

The provision is effective on the date of enactment.

2. Modify charitable contribution rules for donations of patents and other intellectual property (sec. 682 of the bill and secs. 170 and 6050L of the Code)

PRESENT LAW

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization.[473] In the case of non-cash contributions, the amount of the deduction generally equals the fair market value of the contributed property on the date of the contribution.

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

Charitable contributions of capital gain property generally are deductible at fair market value. Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property are subject to different percentage limitations than other contributions of property. Under present law, certain copyrights are not considered capital assets, in which case the charitable deduction for such copyrights generally is limited to the taxpayer's basis.[474]

In general, a charitable contribution deduction is allowed only for contributions of the donor's entire interest in the contributed prop-

[472] It is assumed that there will be competitive bidding for these contracts by private sector tax collection agencies and that vigorous bidding will drive the overhead costs down.

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

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

erty, and not for contributions of a partial interest.[475] If a taxpayer sells property to a charitable organization for less than the property's fair market value, the amount of any charitable contribution deduction is determined in accordance with the bargain sale rules.[476] In general, if a donor receives a benefit or quid pro quo in return for a contribution, any charitable contribution deduction is reduced by the amount of the benefit received. For contributions of $250 or more, no charitable contribution deduction is allowed unless the donee organization provides a contemporaneous written acknowledgement of the contribution that describes and provides a good faith estimate of the value of any goods or services provided by the donee organization in exchange for the contribution.[477]

Taxpayers are required to obtain a qualified appraisal for donated property with a value of $5,000 or more, and to attach the appraisal to the tax return in certain cases.[478] Under Treasury regulations, a qualified appraisal means an appraisal document that, among other things, (1) relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under section 170;[479] (2) is prepared, signed, and dated by a qualified appraiser; (3) includes (a) a description of the property appraised; (b) the fair market value of such property on the date of contribution and the specific basis for the valuation; (c) a statement that such appraisal was prepared for income tax purposes; (d) the qualifications of the qualified appraiser; and (e) the signature and taxpayer identification number ("TIN") of such appraiser; and (4) does not involve an appraisal fee that violates certain prescribed rules.[480]

REASONS FOR CHANGE

The Committee believes that the value of certain intellectual property, such as patents, copyrights, trademarks, trade names, trade secrets, know-how, software, similar property, or applications or registrations of such property, that is contributed to a charity often is highly speculative. Some donated intellectual property may prove to be worthless, or the initial promise of worth may be diminished by future inventions, marketplace competition, or other factors. Although in theory, such intellectual property may promise significant monetary benefits, the benefits generally will not materialize if the charity does not make the appropriate investments, have the right personnel and equipment, or even have sufficient

[475] Sec. 170(f)(3).
[476] Sec. 1011(b) and Treas. Reg. sec. 1.1011–2.
[477] Sec. 170(f)(8).
[478] Pub. L. No. 98–369, sec. 155(a)(1) through (6) (1984) (providing that not later than December 31, 1984, the Secretary shall prescribe regulations requiring an individual, a closely held corporation, or a personal service corporation claiming a charitable deduction for property (other than publicly traded securities) to obtain a qualified appraisal of the property contributed and attach an appraisal summary to the taxpayer's return if the claimed value of such property (plus the claimed value of all similar items of property donated to one or more donees) exceeds $5,000). Under Pub. L. No. 98–369, a qualified appraisal means an appraisal prepared by a qualified appraiser that includes, among other things, (1) a description of the property appraised; (2) the fair market value of such property on the date of contribution and the specific basis for the valuation; (3) a statement that such appraisal was prepared for income tax purposes; (4) the qualifications of the qualified appraiser; (5) the signature and TIN of such appraiser; and (6) such additional information as the Secretary prescribes in such regulations.
[479] In the case of a deduction first claimed or reported on an amended return, the deadline is the date on which the amended return is filed.
[480] Treas. Reg. sec. 1.170A–13(c)(3).

sustained interest to exploit the intellectual property. The Committee understands that valuation is made yet more difficult in the charitable contribution context because the transferee does not provide full, if any, consideration in exchange for the transferred property pursuant to arm's length negotiations, and there may not be a comparable sales market for such property to use as a benchmark for valuations.

The Committee is concerned that taxpayers with intellectual property are taking advantage of the inherent difficulties in valuing such property and are preparing or obtaining erroneous valuations. In such cases, the charity receives an asset of questionable value, while the taxpayer receives a significant tax benefit. The Committee believes that the excessive charitable contribution deductions enabled by inflated valuations is best addressed by ensuring that the amount of the deduction for charitable contributions of such property may not exceed the taxpayer's basis in the property. The Committee notes that for other types of charitable contributions for which valuation is especially problematic—charitable contributions of property created by the personal efforts of the taxpayer and charitable contributions to certain private foundations—a basis deduction generally is the result under present law.

Although the Committee believes that a deduction of basis is appropriate in this context, the Committee recognizes that some contributions of intellectual property may prove to be of economic benefit to the charity and that donors may need an economic incentive to make such contributions. Accordingly, the Committee believes that it is appropriate to permit donors of intellectual property to receive certain additional charitable contribution deductions in the future but only if the contributed property generates qualified income for the charitable organization.

## EXPLANATION OF PROVISION

The provision provides that if a taxpayer contributes a patent or other intellectual property (other than certain copyrights or inventory) to a charitable organization, the taxpayer's initial charitable deduction is limited to the lesser of the taxpayer's basis in the contributed property or the fair market value of the property. In addition, the taxpayer is permitted to deduct, as a charitable deduction, certain additional amounts in the year of contribution or in subsequent taxable years based on a specified percentage of the qualified donee income received or accrued by the charitable donee with respect to the contributed property. For this purpose, "qualified donee income" includes net income received or accrued by the donee that properly is allocable to the intellectual property itself (as opposed to the activity in which the intellectual property is used).

The amount of any additional charitable deduction is calculated as a sliding-scale percentage of qualified donee income received or accrued by the charitable donee that properly is allocable to the contributed property to the applicable taxable year of the donor, determined as follows:

| Taxable year of donor | Deduction permitted for such taxable year |
|---|---|
| 1st year ending on or after contribution | 100 percent of qualified donee income. |
| 2nd year ending on or after contribution | 100 percent of qualified donee income. |
| 3rd year ending on or after contribution | 90 percent of qualified donee income. |

| Taxable year of donor | Deduction permitted for such taxable year |
|---|---|
| 4th year ending on or after contribution | 80 percent of qualified donee income. |
| 5th year ending on or after contribution | 70 percent of qualified donee income. |
| 6th year ending on or after contribution | 60 percent of qualified donee income. |
| 7th year ending on or after contribution | 50 percent of qualified donee income. |
| 8th year ending on or after contribution | 40 percent of qualified donee income. |
| 9th year ending on or after contribution | 30 percent of qualified donee income. |
| 10th year ending on or after contribution | 20 percent of qualified donee income. |
| 11th year ending on or after contribution | 10 percent of qualified donee income. |
| 12th year ending on or after contribution | 10 percent of qualified donee income. |
| Taxable years thereafter | No deduction permitted. |

An additional charitable deduction is allowed only to the extent that the aggregate of the amounts that are calculated pursuant to the sliding-scale exceed the amount of the deduction claimed upon the contribution of the patent or intellectual property.

No charitable deduction is permitted with respect to any revenues or income received or accrued by the charitable donee after the expiration of the legal life of the patent or intellectual property, or after the tenth anniversary of the date the contribution was made by the donor.

The taxpayer is required to inform the donee at the time of the contribution that the taxpayer intends to treat the contribution as a contribution subject to the additional charitable deduction provisions of the provision. In addition, the taxpayer must obtain written substantiation from the donee of the amount of any qualified donee income properly allocable to the contributed property during the charity's taxable year.[481] The donee is required to file an annual information return that reports the qualified donee income and other specified information relating to the contribution. In instances where the donor's taxable year differs from the donee's taxable year, the donor bases its additional charitable deduction on the qualified donee income of the charitable donee properly allocable to the donee's taxable year that ends within the donor's taxable year.

Under the provision, additional charitable deductions are not available for patents or other intellectual property contributed to a private foundation (other than a private operating foundation or certain other private foundations described in section 170(b)(1)(E)).

Under the provision, the Secretary may prescribe regulations or other guidance to carry out the purposes of the provision, including providing for the determination of amounts to be treated as qualified donee income in certain cases where the donee uses the donated property to further its exempt activities or functions, or as may be necessary or appropriate to prevent the avoidance of the purposes of the provision.

EFFECTIVE DATE

The provision is effective for contributions made after June 3, 2004.

[481] The net income taken into account by the taxpayer may not exceed the amount of qualified donee income reported by the donee to the taxpayer and the IRS under the provision's substantiation and reporting requirements.

### 3. Require increased reporting for noncash charitable contributions (sec. 683 of the bill and sec. 170 of the Code)

PRESENT LAW

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization.[482] In the case of non-cash contributions, the amount of the deduction generally equals the fair market value of the contributed property on the date of the contribution.

In general, if the total charitable deduction claimed for non-cash property exceeds $500, the taxpayer must file IRS Form 8283 (Noncash Charitable Contributions) with the IRS. C corporations (other than personal service corporations and closely-held corporations) are required to file Form 8283 only if the deduction claimed exceeds $5,000.

Taxpayers are required to obtain a qualified appraisal for donated property (other than money and publicly traded securities) with a value of more than $5,000.[483] Corporations (other than a closely-held corporation, a personal service corporation, or an S corporation) are not required to obtain a qualified appraisal. Taxpayers are not required to attach a qualified appraisal to the taxpayer's return, except in the case of contributed art-work valued at more than $20,000. Under Treasury regulations, a qualified appraisal means an appraisal document that, among other things, (1) relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under section 170;[484] (2) is prepared, signed, and dated by a qualified appraiser; (3) includes (a) a description of the property appraised; (b) the fair market value of such property on the date of contribution and the specific basis for the valuation; (c) a statement that such appraisal was prepared for income tax purposes; (d) the qualifications of the qualified appraiser; and (e) the signature and taxpayer identification number of such appraiser; and (4) does not involve an appraisal fee that violates certain prescribed rules.[485]

REASONS FOR CHANGE

Under present law, an individual who contributes property to a charity and claims a deduction in excess of $5,000 must obtain a

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

[483] Pub. L. No. 98–369, sec. 155(a)(1) through (6) (1984) (providing that not later than December 31, 1984, the Secretary shall prescribe regulations requiring an individual, a closely held corporation, or a personal service corporation claiming a charitable deduction for property (other than publicly traded securities) to obtain a qualified appraisal of the property contributed and attach an appraisal summary to the taxpayer's return if the claimed value of such property (plus the claimed value of all similar items of property donated to one or more donees) exceeds $5,000). Under Pub. L. No. 98–369, a qualified appraisal means an appraisal prepared by a qualified appraiser that includes, among other things, (1) a description of the property appraised; (2) the fair market value of such property on the date of contribution and the specific basis for the valuation; (3) a statement that such appraisal was prepared for income tax purposes; (4) the qualifications of the qualified appraiser; (5) the signature and taxpayer identification number of such appraiser; and (6) such additional information as the Secretary prescribes in such regulations.

[484] In the case of a deduction first claimed or reported on an amended return, the deadline is the date on which the amended return is filed.

[485] Treas. Reg. sec. 1.170A–13(c)(3).

qualified appraisal, but a C corporation (other than a closely-held corporation or a personal services corporation) that donates property in excess of $5,000 is not required to obtain such an appraisal. Present law does not require that appraisals, even for large gifts, be attached to a taxpayer's return. The Committee believes that requiring C corporations to obtain a qualified appraisal for charitable contributions of certain property in excess of $5,000, and requiring that appraisals be attached to a taxpayer's return for large gifts, will reduce valuation abuses.

EXPLANATION OF PROVISION

The provision requires increased donor reporting for certain charitable contributions of property other than cash, inventory, or publicly traded securities. The provision extends to all C corporations the present law requirement, applicable to an individual, closely-held corporation, personal service corporation, partnership, or S corporation, that the donor must obtain a qualified appraisal of the property if the amount of the deduction claimed exceeds $5,000. The provision also provides that if the amount of the contribution of property other than cash, inventory, or publicly traded securities exceeds $500,000, then the donor (whether an individual, partnership, or corporation) must attach the qualified appraisal to the donor's tax return. For purposes of the dollar thresholds under the provision, property and all similar items of property donated to one or more donees are treated as one property.

The provision provides that a donor that fails to substantiate a charitable contribution of property, as required by the Secretary, is denied a charitable contribution deduction. If the donor is a partnership or S corporation, the deduction is denied at the partner or shareholder level. The denial of the deduction does not apply if it is shown that such failure is due to reasonable cause and not to willful neglect.

The provision provides that the Secretary may prescribe such regulations as may be necessary or appropriate to carry out the purposes of the provision, including regulations that may provide that some or all of the requirements of the provision do not apply in appropriate cases.

EFFECTIVE DATE

The provision is effective for contributions made after June 3, 2004.

4. Require qualified appraisals for charitable contributions of vehicles (sec. 684 of the bill and sec. 170 of the Code)

PRESENT LAW

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization.[486] In the case of non-cash contributions, the amount of the deduction generally equals the fair market value of the contributed property on the date of the contribution.

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

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

Charitable contributions of capital gain property generally are deductible at fair market value. Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property are subject to different percentage limitations than other contributions of property.

A taxpayer who donates a used automobile to a charitable donee generally deducts the fair market value (rather than the taxpayer's basis) of the automobile. A taxpayer who donates a used automobile generally is permitted to use an established used car pricing guide to determine the fair market value of the automobile, but only if the guide lists a sales price for an automobile of the same make, model and year, sold in the same area, and in the same condition as the donated automobile. Similar rules apply to contributions of other types of vehicles and property, such as boats.

Charities are required to provide donors with written substantiation of donations of $250 or more. Taxpayers are required to report non-cash contributions totaling $500 or more and the method used for determining fair market value.

Taxpayers are required to obtain a qualified appraisal for donated property with a value of $5,000 or more, and to attach the appraisal to the tax return in certain cases.[487] Under Treasury regulations, a qualified appraisal means an appraisal document that, among other things, (1) relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under section 170;[488] (2) is prepared, signed, and dated by a qualified appraiser; (3) includes (a) a description of the property appraised; (b) the fair market value of such property on the date of contribution and the specific basis for the valuation; (c) a statement that such

[487] Pub. L. No. 98–369, sec. 155(a)(1) through (6) (1984) (providing that not later than December 31, 1984, the Secretary shall prescribe regulations requiring an individual, a closely held corporation, or a personal service corporation claiming a charitable deduction for property (other than publicly traded securities) to obtain a qualified appraisal of the property contributed and attach an appraisal summary to the taxpayer's return if the claimed value of such property (plus the claimed value of all similar items of property donated to one or more donees) exceeds $5,000). Under Pub. L. No. 98–369, a qualified appraisal means an appraisal prepared by a qualified appraiser that includes, among other things, (1) a description of the property appraised; (2) the fair market value of such property on the date of contribution and the specific basis for the valuation; (3) a statement that such appraisal was prepared for income tax purposes; (4) the qualifications of the qualified appraiser; (5) the signature and TIN of such appraiser; and (6) such additional information as the Secretary prescribes in such regulations.

[488] In the case of a deduction first claimed or reported on an amended return, the deadline is the date on which the amended return is filed.

appraisal was prepared for income tax purposes; (d) the qualifications of the qualified appraiser; and (e) the signature and taxpayer identification number ("TIN") of such appraiser; and (4) does not involve an appraisal fee that violates certain prescribed rules.[489]

Appraisal fees paid by an individual to determine the fair market value of donated property are deductible as miscellaneous expenses subject to the 2 percent of adjusted gross income limit.[490]

REASONS FOR CHANGE

The Committee is aware that in recent years, charitable organizations increasingly have been soliciting charitable contributions of vehicles, which are promptly sold (by the charity or the charity's agent) at auctions for prices far less than the value claimed by taxpayers for purposes of taking a charitable contribution deduction. The Committee believes that requiring taxpayers to obtain a qualified appraisal of a vehicle at the time of the contribution will help to ensure that the value claimed for a vehicle properly takes into account the vehicle's condition and will prevent donors from making excessive claims of value based on generic pricing guides for vehicles.

EXPLANATION OF PROVISION

The provision allows a charitable deduction for contributions of vehicles for which the taxpayer claims a deduction of more than $250 only if the taxpayer obtains a qualified appraisal of the vehicle. The provision applies to automobiles and other types of motor vehicles manufactured primarily for use on public streets, roads, and highways; boats; and aircraft. The provision does not affect contributions of inventory property. The definition of qualified appraisal generally follows the definition contained in present law, subject to additional regulations or guidance provided by the Secretary. The qualified appraisal of a donated vehicle must be obtained by the taxpayer by the time the contribution is made. Under the provision, the Secretary shall prescribe such regulations or other guidance as may be necessary to carry out the purposes of the provision.

EFFECTIVE DATE

The provision is effective for contributions made after June 3, 2004.

5. Extend the present-law intangible amortization provisions to acquisitions of sports franchises (sec. 685 of the bill and sec. 197 of the Code)

PRESENT LAW

The purchase price allocated to intangible assets (including franchise rights) acquired in connection with the acquisition of a trade or business generally must be capitalized and amortized over a 15-year period.[491] These rules were enacted in 1993 to minimize disputes regarding the proper treatment of acquired intangible assets.

[489] Treas. Reg. sec. 1.170A–13(c)(3).
[490] Rev. Rul. 67–461, 1967–2 C.B. 125.
[491] Sec. 197.

The rules do not apply to a franchise to engage in professional sports and any intangible asset acquired in connection with such a franchise.[492] However, other special rules apply to certain of these intangible assets.

Under section 1056, when a franchise to conduct a sports enterprise is sold or exchanged, the basis of a player contract acquired as part of the transaction is generally limited to the adjusted basis of such contract in the hands of the transferor, increased by the amount of gain, if any, recognized by the transferor on the transfer of the contract. Moreover, not more than 50 percent of the consideration from the transaction may be allocated to player contracts unless the transferee establishes to the satisfaction of the Commissioner that a specific allocation in excess of 50 percent is proper. However, these basis rules may not apply if a sale or exchange of a franchise to conduct a sports enterprise is effected through a partnership.[493] Basis allocated to the franchise or to other valuable intangible assets acquired with the franchise may not be amortizable if these assets lack a determinable useful life.

In general, section 1245 provides that gain from the sale of certain property is treated as ordinary income to the extent depreciation or amortization was allowed on such property. Section 1245(a)(4) provides special rules for recapture of depreciation and deductions for losses taken with respect to player contracts. The special recapture rules apply in the case of the sale, exchange, or other disposition of a sports franchise. Under the special recapture rules, the amount recaptured as ordinary income is the amount of gain not to exceed the greater of (1) the sum of the depreciation taken plus any deductions taken for losses (i.e., abandonment losses) with respect to those player contracts which are initially acquired as a part of the original acquisition of the franchise or (2) the amount of depreciation taken with respect to those player contracts which are owned by the seller at the time of the sale of the sports franchise.

REASONS FOR CHANGE

The present-law rules under section 197 were enacted to minimize disputes regarding the measurement of acquired intangible assets. Prior to the enactment of the rules, there were many disputes regarding the value and useful life of various intangible assets acquired together in a business acquisition. Furthermore, in the absence of a showing of a reasonably determinable useful life, an asset could not be amortized. Taxpayers tended to identify and allocate large amounts of purchase price to assets said to have short useful lives, while the IRS would allocate a large amount of value to intangible assets for which no determinable useful life could be shown (e.g., goodwill), and would deny amortization for that amount of purchase price.

The present-law rules for acquisitions of sports franchises do not eliminate the potential for disputes, because they address only player contracts, while a sports franchise acquisition can involve many intangibles other than player contracts. In addition, disputes may arise regarding the appropriate period for amortization of par-

[492] Sec. 197(e)(6).
[493] *P.D.B. Sports, Ltd.* v. *Comm.*, 109 T.C. 423 (1997).

ticular player contracts. The Committee believes expending taxpayer and government resources disputing these items is an unproductive use of economic resources. The Committee further believes that the section 197 rules should apply to all types of businesses regardless of the nature of their assets.

EXPLANATION OF PROVISION

The provision extends the 15–year recovery period for intangible assets to franchises to engage in professional sports and any intangible asset acquired in connection with the acquisition of such a franchise (including player contracts). Thus, the same rules for amortization of intangibles that apply to other acquisitions under present law will apply to acquisitions of sports franchises. The provision also repeals the special rules under section 1245(a)(4) and makes other conforming changes.

EFFECTIVE DATE

The provision is effective for property acquired after the date of enactment. The amendment to section 1245(a)(4) applies to franchises acquired after the date of enactment.

6. Increase continuous levy for certain Federal payments (sec. 686 of the bill and sec. 6331 of the Code)

PRESENT LAW

If any person is liable for any internal revenue tax and does not pay it within 10 days after notice and demand[494] by the IRS, the IRS may then collect the tax by levy upon all property and rights to property belonging to the person,[495] unless there is an explicit statutory restriction on doing so. A levy is the seizure of the person's property or rights to property. Property that is not cash is sold pursuant to statutory requirements.[496]

A continuous levy is applicable to specified Federal payments.[497] This includes any Federal payment for which eligibility is not based on the income and/or assets of a payee. Thus, a Federal payment to a vendor of goods or services to the government is subject to continuous levy. This continuous levy attaches up to 15 percent of any specified payment due the taxpayer.

REASONS FOR CHANGE

There have recently been reports[498] of abuses of the Federal tax system by some Federal contractors. Consequently, the Committee believes that it is appropriate to increase the permissible percentage of Federal payments subject to levy.

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[494] Notice and demand is the notice given to a person liable for tax stating that the tax has been assessed and demanding that payment be made. The notice and demand must be mailed to the person's last known address or left at the person's dwelling or usual place of business (Code sec. 6303).

[495] Code sec. 6331.

[496] Code secs. 6335–6343.

[497] Code sec. 6331(h).

[498] Some DOD Contractors Abuse the Federal Tax System with Little Consequence, GAO–04–95, February 2004.

EXPLANATION OF PROVISION

The provision permits a levy of up to 100 percent of a Federal payment to a vendor of goods or services to the Government.

EFFECTIVE DATE

The provision is effective on the date of enactment.

7. Modification of straddle rules (sec. 687 of the bill and sec. 1092 of the Code)

PRESENT LAW

*Straddle rules*

*In general*

A "straddle" generally refers to offsetting positions (sometimes referred to as "legs" of the straddle) with respect to actively traded personal property. Positions are offsetting if there is a substantial diminution in the risk of loss from holding one position by reason of holding one or more other positions in personal property. A "position" is an interest (including a futures or forward contract or option) in personal property. When a taxpayer realizes a loss with respect to a position in a straddle, the taxpayer may recognize that loss for any taxable year only to the extent that the loss exceeds the unrecognized gain (if any) with respect to offsetting positions in the straddle.[499] Deferred losses are carried forward to the succeeding taxable year and are subject to the same limitation with respect to unrecognized gain in offsetting positions.

*Positions in stock*

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

Although the straddle rules apply to offsetting positions that consist of stock and an option with respect to stock, the straddle rules generally do not apply if the option is a "qualified covered call option" written by the taxpayer.[500] In general, a qualified covered call option is defined as an exchange-listed option that is not deep-in-the-money and is written by a non-dealer more than 30 days before expiration of the option.

The stock exception from the straddle rules has been largely curtailed by statutory amendment and regulatory interpretation.

[499] Sec. 1092.

[500] However, if the option written by the taxpayer is a qualified covered call option that is in-the-money, then (1) any loss with respect to such option is treated as long-term capital loss if, at the time such loss is realized, gain on the sale or exchange of the offsetting stock held by the taxpayer would be treated as long-term capital gain, and (2) the holding period of such stock does not include any period during which the taxpayer is the grantor of the option (sec. 1092(f)).

Under proposed Treasury regulations, the application of the stock exception essentially would be limited to offsetting positions involving direct ownership of stock and short sales of stock.[501]

*Unbalanced straddles*

When one position with respect to personal property offsets only a portion of one or more other positions ("unbalanced straddles"), the Treasury Secretary is directed to prescribe by regulations the method for determining the portion of such other positions that is to be taken into account for purposes of the straddle rules.[502] To date, no such regulations have been promulgated.

Unbalanced straddles can be illustrated with the following example: Assume the taxpayer holds two shares of stock (i.e., is long) in XYZ stock corporation—share A with a $30 basis and share B with a $40 basis. When the value of the XYZ stock is $45, the taxpayer pays a $5 premium to purchase a put option on one share of the XYZ stock with an exercise price of $40. The issue arises as to whether the purchase of the put option creates a straddle with respect to share A, share B, or both. Assume that, when the value of the XYZ stock is $100, the put option expires unexercised. Taxpayer incurs a loss of $5 on the expiration of the put option, and sells share B for a $60 gain. On a literal reading of the straddle rules, the $5 loss would be deferred because the loss ($5) does not exceed the unrecognized gain ($70) in share A, which is also an offsetting position to the put option—notwithstanding that the taxpayer recognized more gain than the loss through the sale of share B. This problem is exacerbated when the taxpayer has a large portfolio of actively traded personal property that may be offsetting the loss leg of the straddle.

Although Treasury has not issued regulations to address unbalanced straddles, the IRS issued a private letter ruling in 1999 that addressed an unbalanced straddle situation.[503] Under the facts of the ruling, a taxpayer entered into a costless collar with respect to a portion of the shares of a particular stock held by the taxpayer.[504] Other shares were held in an account as collateral for a loan and still other shares were held in excess of the shares used as collateral and the number of shares specified in the collar. The ruling concluded that the collar offset only a portion of the stock (i.e., the number of shares specified in the costless collar) because that number of shares determined the payoff under each option comprising the collar. The ruling further concluded that:

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

[501] Prop. Treas. Reg. sec. 1.1092(d)–2(c).
[502] Sec. 1092(c)(2)(B).
[503] Priv. Ltr. Rul. 199925044 (Feb. 3, 1999).
[504] A costless collar generally is comprised of the purchase of a put option and the sale of a call option with the same trade dates and maturity dates and set such that the premium paid substantially equals the premium received. The collar can be considered as economically similar to a short position in the stock.

ments and methods for identification of positions that are part of a section 1092(b)(2) identified mixed straddle].

*Holding period for dividends-received deduction*

If an instrument issued by a U.S. corporation is classified for tax purposes as stock, a corporate holder of the instrument generally is entitled to a dividends-received deduction for dividends received on that instrument.[505] The dividends-received deduction is allowed to a corporate shareholder only if the shareholder satisfies a 46-day holding period for the dividend-paying stock (or a 91-day holding period for certain dividends on preferred stock).[506] The holding period must be satisfied for each dividend over a period that is immediately before and immediately after the taxpayer becomes entitled to receive the dividend. The 46- or 91-day holding period generally does not include any time during which the shareholder is protected (other than by writing a qualified covered call) from the risk of loss that is otherwise inherent in the ownership of any equity interest.[507]

REASONS FOR CHANGE

The Committee believes that the straddle rules should be modified in several respects. While the present-law rules provide authority for the Secretary to issue guidance concerning unbalanced straddles, the Committee is of the view that such guidance is not forthcoming. Therefore, the Committee believes that it is necessary at this time to provide such guidance by statute. The Committee further believes that it is appropriate to repeal the exception from the straddle rules for positions in stock, particularly in light of statutory changes in the straddle rules and elsewhere in the Code that have significantly diminished the continuing utility of the exception. In addition, the Committee believes that the present-law treatment of physically settled positions under the straddle rules requires clarification.

EXPLANATION OF PROVISION

*Straddle rules*

The bill modifies the straddle rules in three respects: (1) permits taxpayers to identify offsetting positions of a straddle; (2) provides a special rule to clarify the present-law treatment of certain physically settled positions of a straddle; and (3) repeals the stock exception from the straddle rules.

*Identified straddles*

Under the bill, taxpayers generally are permitted to identify the offsetting positions that are components of a straddle at the time the taxpayer enters into a transaction that creates a straddle, in-

[505] Sec. 243. The amount of the deduction is 70 percent of dividends received if the recipient owns less than 20 percent (by vote and value) of stock of the payor. If the recipient owns more than 20 percent of the stock, the deduction is increased to 80 percent. If the recipient owns more than 80 percent of the stock, the deduction is further increased to 100 percent for qualifying dividends.

[506] Sec. 246(c).

[507] Sec. 246(c)(4).

cluding an unbalanced straddle.[508] If there is a loss with respect to any identified position that is part of an identified straddle, the general straddle loss deferral rules do not apply to such loss. Instead, the basis of each of the identified positions that offset the loss position in the identified straddle is increased by an amount that bears the same ratio to the loss as the unrecognized gain (if any) with respect to such offsetting position bears to the aggregate unrecognized gain with respect to all positions that offset the loss position in the identified straddle.[509] Any loss with respect to an identified position that is part of an identified straddle cannot otherwise be taken into account by the taxpayer or any other person to the extent that the loss increases the basis of any identified positions that offset the loss position in the identified straddle.

In addition, the provision provides authority to issue Treasury regulations that would specify (1) the proper methods for clearly identifying a straddle as an identified straddle (and identifying positions as positions in an identified straddle), (2) the application of the identified straddle rules for a taxpayer that fails to properly identify the positions of an identified straddle,[510] and (3) provide an ordering rule for dispositions of less than an entire position that is part of an identified straddle.

*Physically settled straddle positions*

The bill also clarifies the present-law straddle rules with respect to taxpayers that settle a position that is part of a straddle by delivering property to which the position relates. Specifically, the provision clarifies that the present-law straddle loss deferral rules treat as a two-step transaction the physical settlement of a straddle position that, if terminated, would result in the realization of a loss. With respect to the physical settlement of such a position, the taxpayer is treated as having terminated the position for its fair market value immediately before the settlement. The taxpayer then is treated as having sold at fair market value the property used to physically settle the position.

*Stock exception repeal*

The bill also eliminates the exception from the straddle rules for stock (other than the exception relating to qualified covered call options). Thus, offsetting positions comprised of actively traded stock and a position with respect to substantially similar or related property generally constitute a straddle.[511]

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[508] However, to the extent provided by Treasury regulations, taxpayers are not permitted to identify offsetting positions of a straddle if the fair market value of the straddle position already held by the taxpayer at the creation of the straddle is less than its adjusted basis in the hands of the taxpayer.

[509] For this purpose, "unrecognized gain" is the excess of the fair market value of an identified position that is part of an identified straddle at the time the taxpayer incurs a loss with respect to another identified position in the identified straddle, over the fair market value of such position when the taxpayer identified the position as a position in the identified straddle.

[510] For example, although the provision does not require taxpayers to identify any positions of a straddle as an identified straddle, it may be necessary to provide rules requiring all balanced offsetting positions to be included in an identified straddle if a taxpayer elects to identify any of the offsetting positions as an identified straddle.

[511] It is intended that Treasury regulations defining substantially similar or related property for this purpose will continue to apply subsequent to repeal of the stock exception and generally will constitute the exclusive definition of a straddle with respect to offsetting positions involving stock. See Prop. Treas. Reg. sec. 1.1092(d)–2(b). However, the general straddles rules regarding substantial diminution in risk of loss will continue to apply to stock of corporations formed or availed of to take positions in personal property that offset positions taken by the shareholder.

*Dividends-received deduction holding period*

The bill also modifies the required 46- or 91–day holding period for the dividends-received deduction by providing that the holding period does not include any time during which the shareholder is protected from the risk of loss otherwise inherent in the ownership of any equity interest if the shareholder obtains such protection by writing an in-the-money call option on the dividend-paying stock.

EFFECTIVE DATE

The provision is effective for positions established on or after the date of enactment that substantially diminish the risk of loss from holding offsetting positions (regardless of when such offsetting position was established).

8. Add vaccines against hepatitis A to the list of taxable vaccines (sec. 688 of the bill and sec. 4132 of the Code)

PRESENT LAW

A manufacturer's excise tax is imposed at the rate of 75 cents per dose[512] on the following vaccines routinely recommended for administration to children: diphtheria, pertussis, tetanus, measles, mumps, rubella, polio, HIB (haemophilus influenza type B), hepatitis B, varicella (chicken pox), rotavirus gastroenteritis, and streptococcus pneumoniae. The tax applied to any vaccine that is a combination of vaccine components equals 75 cents times the number of components in the combined vaccine.

Amounts equal to net revenues from this excise tax are deposited in the Vaccine Injury Compensation Trust Fund to finance compensation awards under the Federal Vaccine Injury Compensation Program for individuals who suffer certain injuries following administration of the taxable vaccines. This program provides a substitute Federal, "no fault" insurance system for the State-law tort and private liability insurance systems otherwise applicable to vaccine manufacturers. All persons immunized after September 30, 1988, with covered vaccines must pursue compensation under this Federal program before bringing civil tort actions under State law.

REASONS FOR CHANGE

The Committee is aware that the Centers for Disease Control and Prevention have recommended that children in 17 highly endemic States be inoculated with a hepatitis A vaccine. The population of children in the affected States exceeds 20 million. Several of the affected States mandate childhood vaccination against hepatitis A. The Committee is aware that the Advisory Commission on Childhood Vaccines has recommended that the vaccine excise tax be extended to cover vaccines against hepatitis A. For these reasons, the Committee believes it is appropriate to include vaccines against hepatitis A as part of the Vaccine Injury Compensation Program. Making the hepatitis A vaccine taxable is a first step.[513] In the unfortunate event of an injury related to this vaccine, fami-

[512] Sec. 4131.

[513] The Committee recognizes that, to become covered under the Vaccine Injury Compensation Program, the Secretary of Health and Human Services also must list the hepatitis A vaccine on the Vaccine Injury Table.

lies of injured children are eligible for the no-fault arbitration system established under the Vaccine Injury Compensation Program rather than going to Federal Court to seek compensatory redress.

EXPLANATION OF PROVISION

The provision adds any vaccine against hepatitis A to the list of taxable vaccines.

EFFECTIVE DATE

The provision is effective for vaccines sold beginning on the first day of the first month beginning more than four weeks after the date of enactment.

9. Add vaccines against influenza to the list of taxable vaccines (sec. 689 of the bill and sec. 4132 of the Code)

PRESENT LAW

A manufacturer's excise tax is imposed at the rate of 75 cents per dose[514] on the following vaccines routinely recommended for administration to children: diphtheria, pertussis, tetanus, measles, mumps, rubella, polio, HIB (haemophilus influenza type B), hepatitis B, varicella (chicken pox), rotavirus gastroenteritis, and streptococcus pneumoniae. The tax applied to any vaccine that is a combination of vaccine components equals 75 cents times the number of components in the combined vaccine.

Amounts equal to net revenues from this excise tax are deposited in the Vaccine Injury Compensation Trust Fund to finance compensation awards under the Federal Vaccine Injury Compensation Program for individuals who suffer certain injuries following administration of the taxable vaccines. This program provides a substitute Federal, "no fault" insurance system for the State-law tort and private liability insurance systems otherwise applicable to vaccine manufacturers. All persons immunized after September 30, 1988, with covered vaccines must pursue compensation under this Federal program before bringing civil tort actions under State law.

REASONS FOR CHANGE

The Committee understands that on October 15, 2003, the Advisory Committee on Immunization Practices of the Centers for Disease Control and Prevention issued a recommendation for the routine annual vaccination of infants six to 23 months of age with an inactivated influenza vaccine licensed by FDA. This is the first recommendation for "routine use" in children although trivalent influenza vaccine products have long been available and approved for use in children of varying ages and these vaccines have long been recommended for use by seniors. For these reasons, the Committee believes it is appropriate to include trivalent vaccines against influenza as part of the Vaccine Injury Compensation Program. Making an influenza vaccine taxable is a first step.[515] In the unfortunate event of an injury related to these vaccines, an injured individual is eligible for the no-fault arbitration system established under the

[514] Sec. 4131.

[515] The Committee recognizes that, to become covered under the Vaccine Injury Compensation Program, the Secretary of Health and Human Services also must list each trivalent vaccine against influenza on the Vaccine Injury Table.

Vaccine Injury Compensation Program rather than going to Federal Court to seek compensatory redress.

EXPLANATION OF PROVISION

The provision adds any trivalent vaccine against influenza to the list of taxable vaccines.

EFFECTIVE DATE

The provision is effective for vaccines sold or used beginning on the later of the first day of the first month beginning more than four weeks after the date of enactment or the date on which the Secretary of Health and Human Services lists any such vaccine for purpose of compensation for any vaccine-related injury or death through the Vaccine Injury Compensation Trust Fund.

10. Extension of IRS user fees (sec. 690 of the bill and sec. 7528 of the Code)

PRESENT LAW

The IRS provides written responses to questions of individuals, corporations, and organizations relating to their tax status or the effects of particular transactions for tax purposes. The IRS generally charges a fee for requests for a letter ruling, determination letter, opinion letter, or other similar ruling or determination.[516] Public Law 108–89[517] extended the statutory authorization for these user fees through December 31, 2004, and moved the statutory authorization for these fees into the Code.[518]

REASONS FOR CHANGE

The Committee believes that it is appropriate to provide a further extension of the applicability of these user fees.

EXPLANATION OF PROVISION

The provision extends the statutory authorization for these user fees through September 30, 2014.

EFFECTIVE DATE

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

11. Extension of customs user fees (sec. 691 of the bill)

PRESENT LAW

Section 13031 of the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) (P.L. 99–272), authorized the Secretary of the Treasury to collect certain service fees. Section 412 (P.L 107–

[516] These user fees were originally enacted in section 10511 of the Revenue Act of 1987 (Pub. Law No. 100–203, December 22, 1987). Public Law 104–117 (An Act to provide that members of the Armed Forces performing services for the peacekeeping efforts in Bosnia and Herzegovina, Croatia, and Macedonia shall be entitled to tax benefits in the same manner as if such services were performed in a combat zone, and for other purposes (March 20, 1996)) extended the statutory authorization for these user fees through September 30, 2003.

[517] 117 Stat. 1131; H.R. 3146, signed by the President on October 1, 2003.

[518] That Public Law also moved into the Code the user fee provision relating to pension plans that was enacted in section 620 of the Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub. L. 107–16, June 7, 2001).

296) of the Homeland Security Act of 2002 authorized the Secretary of the Treasury to delegate such authority to the Secretary of Homeland Security. Provided for under 19 U.S.C. 58c, these fees include: processing fees for air and sea passengers, commercial trucks, rail cars, private aircraft and vessels, commercial vessels, dutiable mail packages, barges and bulk carriers, merchandise, and Customs broker permits. COBRA was amended on several occasions but most recently by P.L. 108–121 which extended authorization for the collection of these fees through March 1, 2005.[519]

REASONS FOR CHANGE

The Committee believes it is important to extend these fees to cover the expenses of the services provided. However, the Committee also believes it is important that any fee imposed be a true user fee. That is, the Committee believes that when the Congress authorizes the executive branch to assess user fees, those fees must be determined to reflect only the cost of providing the service for which the fee is assessed.

EXPLANATION OF PROVISION

The provision extends the passenger and conveyance processing fees and the merchandise processing fees authorized under the Consolidated Omnibus Budget Reconciliation Act of 1985 through September 30, 2014. For fiscal years after September 30, 2005, the Secretary is to charge fees in amount that are reasonably related to the costs of providing customs services in connection with the activity or item for which the fee is charged.

The provision also includes a Sense of the Congress that the fees set forth in paragraphs (1) through (8) of subsection (a) of section 13031 of the Consolidated Omnibus Budget Reconciliation Act of 1985 have been reasonably related to the costs of providing customs services in connection with the activities or items for which the fees have been charged under such paragraphs. The Sense of Congress also states that the fees collected under such paragraphs have not exceeded, in the aggregate, the amounts paid for the costs described in subsection (f)(3)(A) incurred in providing customs services in connection with the activities or items for which the fees were charged under such paragraphs.

The provision further provides that the Secretary conduct a study of all the fees collected by the Department of Homeland Security, and shall submit to the Congress, not later than September 30, 2005, a report containing the recommendations of the Secretary on what fees should be eliminated, what the rate of fees retains should be, and any other recommendations with respect to the fees that the Secretary considers appropriate.

EFFECTIVE DATE

The provisions are effective upon the date of enactment.

[519] Sec. 201; 117 Stat. 1335.

## TITLE VII—MARKET REFORM FOR TOBACCO GROWERS

(Secs. 701–725 of the bill)

### PRESENT LAW

The current tobacco program has two main components: a supply management component and a price support component. In addition, in 1982, Congress passed the "No-Net-Cost Tobacco Program Act"[520] that assured the tobacco program would run at no-net cost to the Federal government.

*Supply management*

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

*Support price*

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

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

*No-net-cost assessment*

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

When tobacco is not contracted, it is sold at an auction sale barn. At the auction sale barn, each lot of tobacco goes to the highest bidder, unless that bid does not exceed the government's loan price. When the bid does not exceed this price, the farmer may choose to be paid the loan price by a cooperative, with money borrowed from the Commodity Credit Corporation ("CCC"). In such cases, the tobacco is consigned to the cooperative (known as a price stabilization cooperative), which redries, packs, and stores the tobacco as collateral for the CCC. The cooperative, acting as an agent for the CCC, later sells the tobacco, with the proceeds going to repay the loan plus interest. If the cooperative does not recover the cost of the loan plus interest, the Secretary of Agriculture assesses growers, purchasers and importers of tobacco in order to repay the dif-

[520] Pub. L. No. 97–218 (1982).

ference. All growers, purchasers and importers of tobacco participate in paying these assessments, regardless of whether or not they participate in the loan program.

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

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

REASONS FOR CHANGE

The tobacco price support program was first created in the 1930s. Almost seventy years later, this depression era program is no longer achieving its stated mission of helping to support tobacco farmers through support prices and marketing quotas.

There are two main reasons for the current failure of the tobacco price support system to achieve its stated goals. First, consumption of tobacco products has declined substantially in recent years. For example, cigarette consumption has declined nearly 36 percent in the United States since 1981, from 640 billion to an estimated 410 billion in 2003.

Second, the current program prevents U.S. tobacco from being price competitive on the domestic and world market. For example, the share of U.S. tobacco in U.S cigarettes has declined from 90 percent in 1960 to 45 percent in 2003. Exports of U.S. tobacco have also declined. At the same time, imports of foreign tobacco have increased to fill the void.

The combined result of declining consumption and the increasing price of U.S. tobacco has been the steady reduction of tobacco quota available to farmers in recent years. Since 1998, the Secretary of Agriculture has cut the national marketing quota by approximately 50 percent. As quota levels have been reduced, so has the volume of domestically-produced tobacco sales. At the same time, quota rental rates have risen, as has the no-net-cost assessment partially paid by growers. This has led to an overall decrease in farm revenue from tobacco production.

The provision eliminates the tobacco program, ending government participation in the growing and marketing of tobacco. Producers are provided transition assistance and quota holders are provided a payment to buy out the asset value of the quota.

EXPLANATION OF PROVISION

The provision repeals the Federal tobacco support program, including marketing quotas and nonrecourse marketing loans.[521]

[521] Secs. 711–712 of the bill.

The provision also provides quota holders $7.00 per pound on their 2002 quota allotment paid in equal installments over five years.[522]

Additionally, the provision provides producers transition payments of $3.00 per pound based on their 2002 quota levels paid in equal installments over five years.[523]

The provision caps payments to quota holders and growers at $9.6 billion over fiscal years 2005 through 2009.[524]

EFFECTIVE DATE

The provision is effective on the date of enactment.

## TITLE VIII—TRADE PROVISIONS

### A. Suspension of Duties on Ceiling Fans

(Sec. 801 of the bill)

PRESENT LAW

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

REASONS FOR CHANGE

The Committee observes that ceiling fans are an energy efficient method of cooling and heating residences and commercial buildings. However, because there is a lack of U.S. production of ceiling fans, the Committee notes that a tariff only serves to increase the cost of ceiling fans to the U.S. consumer. Reducing the tariff on imported ceiling fans is expected to reduce the costs to consumers and encourage energy conservation.

EXPLANATION OF PROVISION

The provision agreement suspends the present customs duty applicable to ceiling fans through December 31, 2006.

EFFECTIVE DATE

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

### B. Suspension of Duties on Nuclear Steam Generators

(Sec. 802 of the bill)

PRESENT LAW

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

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[522] Sec. 722 of the bill.
[523] Sec. 723 of the bill.
[524] Sec. 725 of the bill.

REASONS FOR CHANGE

The Committee notes that nuclear steam generators are essential components to nuclear electricity plants, but at the present time, there is a lack of U.S. production of nuclear steam generators. Therefore the Committee concludes that a tariff only serves to increase the cost of these products to the U.S. purchasers. Reducing the tariff on imported nuclear steam generators is expected to encourage installation of more modern and energy efficient equipment and to reduce the costs to consumers of electricity.

EXPLANATION OF PROVISION

The provision extends the present-law suspension of customs duty applicable to nuclear steam generators through December 31, 2008.

EFFECTIVE DATE

The provision is effective on the date of enactment.

C. SUSPENSION OF DUTIES ON NUCLEAR REACTOR VESSEL HEADS

(Sec. 802 of the bill)

PRESENT LAW

According to section 5202 of the Trade Act of 2002, nuclear reactor vessel heads are classified under subheading 8401.40.00 of the Harmonized Tariff Schedule of the United States and enter the United States with a column 1 duty rate of 3.3 percent.

REASONS FOR CHANGE

The Committee notes that nuclear reactor vessel heads are essential components to nuclear electricity plants, but at the present time, there is a lack of U.S. production of nuclear reactor vessel heads. Therefore the Committee concludes that a tariff only serves to increase the cost of these products to the U.S. purchasers. Reducing the tariff on imported nuclear reactor vessel heads is expected to encourage installation of more modern and energy efficient equipment and to reduce the costs to consumers of electricity.

EXPLANATION OF PROVISION

The provision temporarily suspends the present customs duty applicable to nuclear reactor vessel heads for column 1 countries through December 31, 2008.

EFFECTIVE DATE

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

## II. VOTES OF THE COMMITTEE

In compliance with clause 3(b) of rule XIII of the Rules of the House of Representatives, the following statements are made concerning the votes of the Committee on Ways and Means in its consideration of the bill, H.R. 4520.

MOTION TO REPORT THE BILL

The bill, H.R. 4520, as amended, was ordered favorably reported by a rollcall vote of 27 yeas to 9 nays (with a quorum being present). The vote was as follows:

| Representatives | Yea | Nay | Present | Representatives | Yea | Nay | Present |
|---|---|---|---|---|---|---|---|
| Mr. Thomas | X | | | Mr. Rangel | | X | |
| Mr. Crane | X | | | Mr. Stark | | | |
| Mr. Shaw | X | | | Mr. Matsui | | | |
| Mrs. Johnson | X | | | Mr. Levin | | X | |
| Mr. Houghton | X | | | Mr. Cardin | | X | |
| Mr. Herger | X | | | Mr. McDermott | | X | |
| Mr. McCrery | X | | | Mr. Kleczka | | | |
| Mr. Camp | X | | | Mr. Lewis (GA) | | X | |
| Mr. Ramstad | X | | | Mr. Neal | | | |
| Mr. Nussle | X | | | Mr. McNulty | | | |
| Mr. Johnson | X | | | Mr. Jefferson | X | | |
| Ms. Dunn | X | | | Mr. Tanner | X | | |
| Mr. Collins | X | | | Mr. Becerra | | X | |
| Mr. Portman | X | | | Mr. Doggett | | X | |
| Mr. English | X | | | Mr. Pomeroy | | X | |
| Mr. Hayworth | X | | | Mr. Sandlin | X | | |
| Mr. Weller | X | | | Ms. Tubbs Jones | | X | |
| Mr. Hulshof | X | | | | | | |
| Mr. McInnis | X | | | | | | |
| Mr. Lewis (KY) | X | | | | | | |
| Mr. Foley | X | | | | | | |
| Mr. Brady | X | | | | | | |
| Mr. Ryan | X | | | | | | |
| Mr. Cantor | X | | | | | | |

VOTES ON AMENDMENTS

A rollcall vote was conducted on the following amendments to the Chairman's amendment in the nature of a substitute.

An amendment by Mr. Rangel, which would strike all of the Chairman's amendment in the nature of a substitute, except for Title VII, and insert new provisions, was defeated by a rollcall vote of 11 yeas to 25 nays. The vote was as follows:

| Representatives | Yea | Nay | Present | Representatives | Yea | Nay | Present |
|---|---|---|---|---|---|---|---|
| Mr. Thomas | | X | | Mr. Rangel | X | | |
| Mr. Crane | | X | | Mr. Stark | | | |
| Mr. Shaw | | X | | Mr. Matsui | | | |
| Mrs. Johnson | | X | | Mr. Levin | X | | |
| Mr. Houghton | | X | | Mr. Cardin | X | | |
| Mr. Herger | | X | | Mr. McDermott | X | | |
| Mr. McCrery | | X | | Mr. Kleczka | | | |
| Mr. Camp | | X | | Mr. Lewis (GA) | X | | |
| Mr. Ramstad | | X | | Mr. Neal | | | |
| Mr. Nussle | | X | | Mr. McNulty | | | |
| Mr. Johnson | | X | | Mr. Jefferson | X | | |
| Ms. Dunn | | X | | Mr. Tanner | X | | |
| Mr. Collins | | X | | Mr. Becerra | X | | |
| Mr. Portman | | X | | Mr. Doggett | X | | |
| Mr. English | | X | | Mr. Pomeroy | | X | |
| Mr. Hayworth | | X | | Mr. Sandlin | X | | |
| Mr. Weller | | X | | Ms. Tubbs Jones | X | | |
| Mr. Hulshof | | X | | | | | |
| Mr. McInnis | | X | | | | | |
| Mr. Lewis (KY) | | X | | | | | |
| Mr. Foley | | X | | | | | |
| Mr. Brady | | X | | | | | |
| Mr. Ryan | | X | | | | | |

| Representatives | Yea | Nay | Present | Representatives | Yea | Nay | Present |
|---|---|---|---|---|---|---|---|
| Mr. Cantor | | X | | | | | |

An amendment by Mr. McDermott, which would strike Section 681, which would have permitted private sector debt collection companies to collect taxes, was defeated by a rollcall vote of 12 yeas to 24 nays. The vote was as follows:

| Representatives | Yea | Nay | Present | Representatives | Yea | Nay | Present |
|---|---|---|---|---|---|---|---|
| Mr. Thomas | | X | | Mr. Rangel | X | | |
| Mr. Crane | | X | | Mr. Stark | | | |
| Mr. Shaw | | X | | Mr. Matsui | | | |
| Mrs. Johnson | | X | | Mr. Levin | X | | |
| Mr. Houghton | | X | | Mr. Cardin | X | | |
| Mr. Herger | | X | | Mr. McDermott | X | | |
| Mr. McCrery | | X | | Mr. Kleczka | | | |
| Mr. Camp | | X | | Mr. Lewis (GA) | X | | |
| Mr. Ramstad | | X | | Mr. Neal | | | |
| Mr. Nussle | | X | | Mr. McNulty | | | |
| Mr. Johnson | | X | | Mr. Jefferson | X | | |
| Ms. Dunn | | X | | Mr. Tanner | X | | |
| Mr. Collins | | X | | Mr. Becerra | X | | |
| Mr. Portman | | X | | Mr. Doggett | X | | |
| Mr. English | | X | | Mr. Pomeroy | X | | |
| Mr. Hayworth | | X | | Mr. Sandlin | X | | |
| Mr. Weller | | X | | Ms. Tubbs Jones | X | | |
| Mr. Hulshof | | X | | | | | |
| Mr. McInnis | | X | | | | | |
| Mr. Lewis (KY) | | X | | | | | |
| Mr. Foley | | X | | | | | |
| Mr. Brady | | X | | | | | |
| Mr. Ryan | | X | | | | | |
| Mr. Cantor | | X | | | | | |

An amendment by Mr. Sandlin, which would strike Title III and replace Title V with a new Title V that would create a permanent deduction for State and local general retail sales taxes, was defeated by a rollcall vote of 8 yeas to 28 nays. The vote was as follows:

| Representatives | Yea | Nay | Present | Representatives | Yea | Nay | Present |
|---|---|---|---|---|---|---|---|
| Mr. Thomas | | X | | Mr. Rangel | X | | |
| Mr. Crane | | X | | Mr. Stark | | | |
| Mr. Shaw | | X | | Mr. Matsui | | | |
| Mrs. Johnson | | X | | Mr. Levin | | X | |
| Mr. Houghton | | X | | Mr. Cardin | | X | |
| Mr. Herger | | X | | Mr. McDermott | X | | |
| Mr. McCrery | | X | | Mr. Kleczka | | | |
| Mr. Camp | | X | | Mr. Lewis (GA) | X | | |
| Mr. Ramstad | | X | | Mr. Neal | | | |
| Mr. Nussle | | X | | Mr. McNulty | | | |
| Mr. Johnson | | X | | Mr. Jefferson | X | | |
| Ms. Dunn | | X | | Mr. Tanner | X | | |
| Mr. Collins | | X | | Mr. Becerra | | X | |
| Mr. Portman | | X | | Mr. Doggett | X | | |
| Mr. English | | X | | Mr. Pomeroy | | X | |
| Mr. Hayworth | | X | | Mr. Sandlin | X | | |
| Mr. Weller | | X | | Ms. Tubbs Jones | X | | |
| Mr. Hulshof | | X | | | | | |
| Mr. McInnis | | X | | | | | |
| Mr. Lewis (KY) | | X | | | | | |
| Mr. Foley | | X | | | | | |
| Mr. Brady | | X | | | | | |
| Mr. Ryan | | X | | | | | |

| Representatives | Yea | Nay | Present | Representatives | Yea | Nay | Present |
|---|---|---|---|---|---|---|---|
| Mr. Cantor ..... | ..... | X | | | | | |

## III. BUDGET EFFECTS OF THE BILL

### A. Committee Estimate of Budgetary Effects

In compliance with clause 3(d)(2) of the rule XIII of the Rules of the House of Representatives, the following statement is made concerning the effects on the budget of the revenue provisions of the bill, H.R. 4520 as reported.

The bill is estimated to have the following effects on budget receipts for fiscal years 2003–2008:

**ESTIMATED REVENUE EFFECTS OF H.R. 4520,**
**THE "AMERICAN JOBS CREATION ACT OF 2004,"**
**AS REPORTED BY THE COMMITTEE ON WAYS AND MEANS**

**Fiscal Years 2004 - 2009**

*[Millions of Dollars]*

| Provision | Effective | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2004-09 |
|---|---|---|---|---|---|---|---|---|
| **I. Provisions Relating to Trade Compliance and Reduction in Corporate Income Tax Rates** | | | | | | | | |
| A. Repeal of Exclusion for Extraterritorial Income | ta 12/31/04 [1] | --- | 461 | 1,436 | 3,636 | 5,505 | 5,765 | 16,803 |
| B. Reduction in Corporate Income Tax Rates | | | | | | | | |
| 1. Corporate tax rate reductions for manufacturing and other specified income, including maximum 34% rate for 2005 and 2006, and 32% for 2007 and thereafter [2] | tyba 12/31/04 | --- | -1,658 | -2,410 | -4,130 | -6,747 | -7,332 | -22,277 |
| 2. 33% corporate income tax rate applies to taxable income over $75,000 and under $1 million in 2005 through 2007; 32% corporate income tax rate applies to taxable income over $75,000 and under: $1 million in 2008 through 2010, $5 million in 2011 and 2012, and $20 million in 2013 and thereafter for non-manufacturing income [2] | tyba 12/31/04 | --- | -448 | -723 | -788 | -1,025 | -1,103 | -4,088 |
| **Total of Provisions Relating to Trade Compliance and Reduction in Corporate Income Tax Rates** | | **---** | **-1,645** | **-1,697** | **-1,282** | **-2,267** | **-2,670** | **-9,562** |
| **II. Provisions Relating to Job Creation Tax Incentives for Manufacturers, Small Business, and Farmers** | | | | | | | | |
| A. Two-Year Extension of Increased Expensing for Small Business - Increase section 179 expensing from $25,000 to $100,000 and increase the phaseout threshold amount from $200,000 to $400,000; include software in section 179 property; and extend indexing of both the deduction limit and the phaseout threshold (sunset after 2007) | tyba 12/31/05 | --- | --- | -3,814 | -6,636 | -488 | 3,786 | -7,152 |
| B. Depreciation | | | | | | | | |
| 1. 15-year straight-line cost recovery for qualified leasehold improvements (sunset after 2005) | ppisa DOE | -12 | -76 | -169 | -207 | -202 | -193 | -859 |
| 2. 15-year straight-line cost recovery for qualified restaurant improvements (sunset after 2005) | ppisa DOE | -51 | -218 | -35 | -42 | -42 | -42 | -430 |

| Provision | Effective | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2004-09 |
|---|---|---|---|---|---|---|---|---|
| 3. Extended placed in service date for bonus depreciation for certain aircraft (excluding aircraft used in the transportation industry) | ppisa 9/10/01 [3] | --- | -1,265 | -175 | 576 | 346 | 271 | -247 |
| 4. Special placed in service rule for bonus depreciation for certain property subject to syndication | sa 6/4/04 | -3 | -24 | 8 | 6 | 4 | 4 | -5 |
| C. S Corporation Reform and Simplification | | | | | | | | |
| 1. Treat members of family as one shareholder (3 generations without limit) (includes interaction with line 2 below) | generally tyba 12/31/04 | --- | -1 | -3 | -5 | -6 | -7 | -23 |
| 2. Increase in number of eligible shareholders to 100 | tyba 12/31/04 | --- | -18 | -43 | -56 | -66 | -74 | -257 |
| 3. Expansion of bank S corporation eligible shareholders to include IRAs | DOE | -4 | -29 | -34 | -36 | -37 | -39 | -179 |
| 4. Disregard unexercised powers of appointment in determining potential current beneficiaries of ESBT | tyba 12/31/04 | *Negligible Revenue Effect* | | | | | | |
| 5. Transfer of suspended losses incident to divorce | tyba 12/31/04 | --- | -1 | -2 | -2 | -2 | -3 | -11 |
| 6. Use of passive activity loss by subchapter S trust income beneficiaries | tma 12/31/04 | --- | -1 | -1 | -1 | -1 | -1 | -4 |
| 7. Exclusion of investment securities income from passive income test for bank S corporations | tyba 12/31/04 | *Negligible Revenue Effect* | | | | | | |
| 8. Treatment of bank director shares | tyba 12/31/04 | --- | -5 | -11 | -13 | -15 | -16 | -60 |
| 9. Relief from inadvertently invalid qualified subchapter S subsidiary elections and terminations | tyba 12/31/04 | --- | -1 | -1 | -1 | -1 | -1 | -7 |
| 10. Information returns for qualified subchapter S subsidiaries | tyba 12/31/04 | *No Revenue Effect* | | | | | | |
| 11. Repayment of loan for qualifying employer securities | dma 12/31/04 | --- | [4] | [4] | [4] | [4] | [4] | -2 |
| D. Alternative Minimum Tax Relief | | | | | | | | |
| 1. Repeal the 90% limitation on the use of foreign tax credits against the AMT | tyba 12/31/04 | --- | -265 | -395 | -376 | -361 | -348 | -1,745 |
| 2. Expansion of exemption from alternative minimum tax for small corporations to $20 million | tyba 12/31/05 | --- | --- | -99 | -127 | -108 | -101 | -434 |
| 3. Coordinate farmer income averaging and the AMT | tyba 12/31/03 | [4] | -2 | -2 | -3 | -4 | -5 | -17 |
| E. Restructuring of Incentives for Alcohol Fuels, Etc. | | | | | | | | |
| 1. Provide excise tax credit (in lieu of reduced tax rate on gasoline) to certain blenders of alcohol fuel mixtures (sunset 12/31/10) | fsoua 9/30/04 | *No Revenue Effect* | | | | | | |
| 2. Provide that all alcohol fuels excise tax credits and payments are paid from the General Fund [5] | tra 9/30/04 & apa 9/30/04 | --- | --- | --- | --- | --- | --- | --- |
| 3. Repeal reduced-rate sales of gasoline for blending with alcohol and reduced-rate sales of alcohol fuel blends | fsoua 9/30/04 | --- | 22 | 23 | 23 | 23 | 22 | 113 |

| Provision | Effective | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2004-09 |
|---|---|---|---|---|---|---|---|---|
| 4. Provide outlay payments (in lieu of excise tax credits and refunds) to producers of alcohol fuel mixtures: | | | | | | | | |
| a. Outlay effects [6] [7] | fsoua 9/30/04 | --- | -105 | -114 | -116 | -117 | -119 | -571 |
| b. Revenue effects | fsoua 9/30/04 | --- | 105 | 114 | 116 | 117 | 119 | 571 |
| 5. Transfer full amount of alcohol fuel excise taxes to the Highway Trust Fund (i.e., repeal 2.5/2.8 cents transfer to General Fund) | tia 9/30/03 | *No Revenue Effect* | | | | | | |
| 6. Transfer full amount of motorboat fuel taxes and certain small engine fuel taxes to the Aquatic Resources Trust Fund | tia 9/30/03 | *No Revenue Effect* | | | | | | |
| F. Exclusion of Incentive Stock Options and Employee Stock Purchase Plan Stock Options From Wages | saptoea DOE | *No Revenue Effect* | | | | | | |
| G. Incentives to Reinvest Foreign Earnings in the United States | [8] | 2,805 | 161 | -2,385 | -1,307 | -858 | -569 | -2,153 |
| H. Other Incentive Provisions | | | | | | | | |
| 1. Special rules for livestock sold on account of weather-related conditions - Increase reinvestment period from 2 to 4 years for involuntary conversion of livestock due to drought, flood, or other weather-related conditions | trda 12/31/02 | --- | -18 | -7 | -4 | -3 | -3 | -35 |
| 2. Payment of dividends on stock of cooperatives without reducing patronage dividends | dmi tyba DOE | --- | [4] | [4] | -1 | -1 | -1 | -3 |
| 3. Capital gains treatment to apply to outright sales of timber by landowner | sota 12/31/04 | *Negligible Revenue Effect* | | | | | | |
| 4. Distributions from publicly traded partnerships treated as qualifying income for regulated investment company | tyba DOE | --- | -1 | -2 | -3 | -5 | -5 | -16 |
| 5. Improvements related to real estate investment trusts | tyba 12/31/00 & tyba DOE | *Negligible Revenue Effect* | | | | | | |
| 6. Treatment of certain dividends of regulated investment companies | [9] | --- | -7 | -59 | -61 | -63 | -65 | -255 |
| 7. Taxation of certain settlement funds | tyba 12/31/04 | --- | -3 | -6 | -6 | -7 | -7 | -29 |
| 8. Expand human clinical trials expenses qualifying for the orphan drug tax credit | eia DOE | -4 | -12 | -17 | -18 | -18 | -19 | -88 |
| 9. Simplification of excise tax imposed on bows and arrows [10] | asbmpoia 12/31/04 | --- | -1 | -1 | -1 | -1 | -1 | -4 |
| 10. Repeal excise tax on fishing tackle boxes [11] | asbmpoia 12/31/04 | --- | -2 | -3 | -3 | -3 | -4 | -16 |
| 11. Repeal excise tax on sonar devices suitable for finding fish [12] | asbmpoia 12/31/04 | --- | [4] | [4] | [4] | [4] | [4] | -2 |
| 12. Income tax credit for cost of carrying tax-paid distilled spirits in wholesale inventories ($12 per gallon) | tyba 12/31/04 | --- | -13 | -19 | -19 | -20 | -20 | -91 |
| 13. Suspension of the occupational taxes relating to distilled spirits, wine, and beer (sunset 6/30/07) | DOE | -66 | -78 | -78 | -12 | --- | --- | -234 |

| Provision | Effective | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2004-09 |
|---|---|---|---|---|---|---|---|---|
| 14. Modification of unrelated business income limitation on investment in certain debt-financed properties of SBICs | fa DOE | [4] | -1 | -1 | -1 | -1 | -1 | -4 |
| 15. Tonnage tax election for income from international shipping | tyba DOE | [13] | -3 | -5 | -6 | -7 | -7 | -28 |
| 16. Charitable contribution deduction for certain expenses in support of Native Alaska subsistence whaling | cma 12/31/04 | --- | [4] | [4] | [4] | [4] | [4] | -1 |
| **Total of Provisions Relating to Job Creation Tax Incentives for Manufacturers, Small Business, and Farmers** | | **2,665** | **-1,862** | **-7,336** | **-8,342** | **-1,949** | **2,550** | **-14,278** |
| **III. Provisions Relating to Tax Reform and *Simplification for United States Businesses*** | | | | | | | | |
| 1. Interest expense allocation rules | tyba 12/31/08 | --- | --- | --- | --- | --- | -908 | -908 |
| 2. Recharacterize overall domestic loss | If tyba 12/31/06 | --- | --- | --- | -57 | -680 | -713 | -1,450 |
| 3. Reduction to 2 foreign tax credit baskets [14] | tyba 12/31/06 | --- | --- | --- | -615 | -900 | -927 | -2,442 |
| 4. Apply look-through rules for dividends from noncontrolled section 902 corporations | tyba 12/31/02 | -585 | -77 | -51 | -23 | -6 | -1 | -743 |
| 5. Attribution of stock ownership through partnerships in determining section 902 and 960 credits | tyba DOE | [13] | -1 | -3 | -3 | -3 | -3 | -13 |
| 6. Foreign tax credit treatment of deemed payments under section 367(d) | ataro/a 8/5/97 | -22 | -4 | -5 | -5 | -5 | -5 | -46 |
| 7. United States property not to include certain assets of controlled foreign corporations | [15] | --- | -3 | -20 | -21 | -22 | -23 | -89 |
| 8. Election not to use average exchange rate for foreign tax paid other than in functional currency | tyba 12/31/04 | *Negligible Revenue Effect* | | | | | | |
| 9. Eliminate secondary withholding tax with respect to dividends paid by certain foreign corporations | pma 12/31/04 | --- | -2 | -3 | -3 | -3 | -3 | -14 |
| 10. Provide equal treatment for interest paid by foreign partnerships and foreign corporations doing business in the U.S. | tyba 12/31/03 | -1 | -2 | -2 | -2 | -2 | -2 | -11 |
| 11. Look-through treatment of payments between related CFCs under foreign personal holding company income rules | [15] | --- | -77 | -217 | -234 | -255 | -262 | -1,045 |
| 12. Look-through treatment under subpart F for sales of partnership interests | [15] | --- | -39 | -91 | -96 | -101 | -106 | -433 |
| 13. Repeal of rules applicable to foreign personal holding companies and foreign investment companies, personal holding company rules as they apply to foreign corporations, and include in subpart F personal service contract income, as defined under the foreign personal holding company rules | [15] | --- | -25 | -65 | -73 | -81 | -91 | -335 |

| Provision | Effective | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2004-09 |
|---|---|---|---|---|---|---|---|---|
| 14. Determination of foreign personal holding company income with respect to transactions in commodities | teia 12/31/04 | --- | -4 | -10 | -10 | -10 | -10 | -44 |
| 15. Modify treatment of aircraft leasing and shipping income [16] | [15] | --- | -33 | -172 | -98 | -75 | -76 | -454 |
| 16. Modification of exceptions under subpart F for active financing income | [15] | Negligible Revenue Effect | | | | | | |
| 17. Interaction | --- | --- | 4 | 240 | 315 | 375 | 607 | 1,541 |
| **Total of Provisions Relating to Tax Reform and Simplification for United States Businesses** | | **-608** | **-263** | **-399** | **-925** | **-1,768** | **-2,523** | **-6,486** |
| **IV. Extension of Certain Expiring Provisions** | | | | | | | | |
| 1. Treatment of nonrefundable personal credits under the individual alternative minimum tax (sunset 12/31/05) [17] | tyba 12/31/03 | --- | -577 | -1,242 | --- | --- | --- | -1,819 |
| 2. Tax credit for research and experimentation expenses (sunset 12/31/05) | epoia 6/30/04 | -464 | -3,016 | -1,986 | -936 | -678 | -390 | -7,470 |
| 3. Tax credit for electricity production from wind, and closed-loop biomass -- facilities placed in service date (sunset 12/31/05) | fpisa 12/31/03 | -6 | -34 | -69 | -89 | -101 | -116 | -414 |
| 4. Indian employment tax credit (sunset 12/31/05) | 1/1/05 | --- | -25 | -34 | -10 | --- | --- | -68 |
| 5. Work opportunity tax credit (sunset 12/31/05) | wpoifibwa 12/31/03 | -77 | -201 | -181 | -81 | -39 | -23 | -603 |
| 6. Welfare-to-work tax credit (sunset 12/31/05) | wpoifibwa 12/31/03 | -8 | -27 | -39 | -28 | -14 | -7 | -122 |
| 7. Above-the-line deduction for teacher classroom expenses capped at $250 annually (sunset 12/31/05) | tyba 12/31/03 | -42 | -303 | -74 | --- | --- | --- | -419 |
| 8. Accelerated depreciation for business property on Indian reservation (sunset 12/31/05) | 1/1/05 | 2 | -150 | -266 | -101 | 19 | 70 | -426 |
| 9. Enhanced deduction for corporate contributions of computer equipment to public libraries and elementary and secondary schools (sunset tyba 12/31/05) | tyba 12/31/03 | -66 | -132 | -62 | --- | --- | --- | -260 |
| 10. Expensing of "Brownfields" environmental remediation costs (sunset 12/31/05) | epoia 12/31/03 | -146 | -263 | -93 | 32 | 38 | 39 | -394 |
| 11. Availability of medical savings accounts (sunset 12/31/05) | 1/1/04 | Negligible Revenue Effect | | | | | | |
| 12. Suspension of 100 percent-of-net-income limitation on percentage depletion for oil and gas from marginal wells (sunset 12/31/05) | tyba 12/31/03 | -31 | -47 | -16 | --- | --- | --- | -94 |
| 13. Qualified zone academy bonds (sunset 12/31/05) | oia DOE | [4] | -3 | -10 | -20 | -27 | -28 | -89 |
| 14. Tax incentives for investment in the District of Columbia (sunset 12/31/05) | generally DOE & oia 12/31/03 | -74 | -87 | -56 | -18 | -12 | -17 | -264 |
| 15. Extend authority to issue new New York Liberty Zone bonds (sunset 12/31/09) [18] | 1/1/05 | --- | -3 | -17 | -33 | -46 | -57 | -156 |
| 16. Disclosures relating to terrorist activities (sunset 12/31/05): | | | | | | | | |
| a. Extension of authority to make disclosures regarding terrorist activities | dmo/a DOE | No Revenue Effect | | | | | | |

| Provision | Effective | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2004-09 |
|---|---|---|---|---|---|---|---|---|
| b. Technical correction regarding disclosure of taxpayer identity to law enforcement officials investigating terrorist activities | [19] | *No Revenue Effect* | | | | | | |
| 17. Disclosure of tax return information to carry out administration of income contingent repayment of student loans (sunset 12/31/05) [6] | 1/1/05 | *No Revenue Effect* | | | | | | |
| 18. Increase in limit on cover over of rum excise tax revenues (from $10.50 to $13.25 per proof gallon) to Puerto Rico and the Virgin Islands (sunset 12/31/05) | abiUSa 12/31/03 | -33 | -118 | -18 | --- | --- | --- | -169 |
| 19. Joint Committee on Taxation annual report and annual joint hearing on IRS strategic plans | 1/1/04 | *No Revenue Effect* | | | | | | |
| 20. Parity in the application of certain limits to mental health benefits (sunset 12/31/05) [20] | generally bfsfa DOE | --- | -4 | -43 | -10 | --- | --- | -57 |
| 21. Extension of combined employment tax reporting demonstration project (sunset 12/31/05) | do/a DOE | *No Revenue Effect* | | | | | | |
| 22. Clean-fuel vehicles: | | | | | | | | |
| a. Extension of deduction for clean-fuel vehicles | ppisa 12/31/03 | -32 | -87 | -16 | 25 | 16 | 12 | -81 |
| b. Extension of electric vehicle credit | ppisa 12/31/03 | -2 | -3 | -1 | [21] | [21] | [21] | -5 |
| **Total of Extension of Certain Expiring Provisions** | | **-979** | **-5,080** | **-4,223** | **-1,269** | **-844** | **-517** | **-12,910** |
| **V. Deduction of State and Local General Sales Taxes (sunset 12/31/05)** | **tyba 12/31/03** | **---** | **-2,208** | **-1,373** | **---** | **---** | **---** | **-3,581** |
| **VI. Revenue Provisions** | | | | | | | | |
| A. Provisions to Reduce Tax Avoidance Through Individual and Corporate Expatriation | | | | | | | | |
| 1. Tax treatment of expatriated entities | tyea 3/4/03 | 18 | 28 | 24 | 28 | 30 | 32 | 160 |
| 2. 15% excise tax on stock compensation of insiders in expatriated corporations | [22] | 11 | 7 | 7 | 7 | 7 | 7 | 46 |
| 3. Reinsurance of United States risks in foreign jurisdictions | rra DOE | [23] | [23] | [23] | [23] | [23] | [23] | 2 |
| 4. Revision of tax rules for individuals who expatriate | iwea 6/3/04 | 7 | 16 | 21 | 24 | 28 | 32 | 128 |
| 5. Reporting of taxable mergers and acquisitions | aa DOE | 1 | 2 | 3 | 3 | 3 | 3 | 15 |
| 6. Studies | DOE | *No Revenue Effect* | | | | | | |
| B. Tax Shelter Provisions | | | | | | | | |
| 1. Provisions relating to reportable transactions and tax shelters (sections 611, 612, 613, 614, 615, 616, 617, and 618) | various dates after DOE [24] | 10 | 76 | 119 | 120 | 124 | 131 | 580 |
| 2. Modifications to the substantial understatement penalty for nonreportable transactions | tyba DOE | --- | --- | 7 | 15 | 23 | 26 | 71 |
| 3. Modification of actions to enjoin certain conduct related to tax shelters and reportable transactions | da DOE | *Negligible Revenue Effect* | | | | | | |
| 4. Impose a civil penalty (of up to $5,000) on failure to report interest in foreign financial accounts | voa DOE | --- | --- | [23] | [23] | [23] | [23] | 1 |

| Provision | Effective | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2004-09 |
|---|---|---|---|---|---|---|---|---|
| 5. Regulation of individuals practicing before the Department of Treasury | ata DOE | No Revenue Effect | | | | | | |
| 6. Treatment of stripped interest in bond and preferred stock funds | pada DOE | 1 | 13 | 11 | 8 | 5 | 3 | 41 |
| 7. Minimum holding period for foreign tax credit on withholding tax on income other than dividends | apoamt 30da DOE | [23] | 3 | 3 | 3 | 3 | 4 | 16 |
| 8. Disallowance of certain partnership loss transfers with partner level loss limits for transfer of interest in electing investment partnerships | ctada DOE | 2 | 32 | 56 | 62 | 61 | 55 | 268 |
| 9. No reduction of basis under section 734 in stock held by partnership in corporate partner | Da DOE | 12 | 16 | 24 | 29 | 33 | 35 | 148 |
| 10. Repeal of special rules for FASITs | after 12/31/04 | --- | [23] | [23] | [23] | [23] | [23] | 2 |
| 11. Limitation on transfer of built-in losses on REMIC residuals | ta DOE | --- | 1 | 2 | 4 | 6 | 8 | 21 |
| 12. Clarification of banking business for purposes of determining investment of earnings in United States property | DOE | --- | 20 | 17 | 17 | 18 | 19 | 91 |
| 13. Increase the net-written-premium threshold permitting certain small insurance companies to be taxed on investment income to $1.89 million and index for inflation | tyba 12/31/03 | -4 | -9 | -9 | -9 | -10 | -10 | -52 |
| 14. Deny deduction for interest paid to the IRS on underpayments involving certain tax motivated transactions | tyba DOE | --- | --- | 1 | 1 | 3 | 4 | 9 |
| 15. Clarification of rules for payment of estimated tax for certain deemed asset sales | toa DOE | 14 | 51 | 18 | 7 | 3 | 3 | 96 |
| 16. Exclusion of like-kind exchange property from nonrecognition treatment on the sale or exchange of a principal residence | sopra DOE | [23] | 11 | 13 | 15 | 17 | 19 | 75 |
| 17. Prevent mismatching of deductions and income inclusions in transactions with related foreign persons | pao/a DOE | 5 | 40 | 82 | 80 | 33 | 35 | 275 |
| 18. Exclusion from gross income for interest on overpayments of income tax by individuals | iri cyba DOE | --- | 1,054 | -105 | -108 | -111 | -114 | 616 |
| 19. Deposits made to suspend the running of interest on potential underpayments | Dma DOE | 27 | 123 | -6 | -6 | -6 | -6 | 127 |
| 20. Authorize IRS to enter into installment agreements that provide for partial payment | iaeio/a DOE | 24 | 33 | 10 | [21] | [21] | [21] | 67 |
| 21. Affirmation of consolidated return regulation authority | [25] | Negligible Revenue Effect | | | | | | |
| 22. Reform the tax treatment for leasing transactions with tax-indifferent parties | [26] | 109 | 450 | 842 | 1,202 | 1,578 | 1,915 | 6,096 |
| C. Reduction of Fuel Tax Evasion | | | | | | | | |
| 1. Exemption from certain excise taxes for mobile machinery vehicles | DOE [27] | --- | 76 | 95 | 95 | 95 | 95 | 456 |

| Provision | Effective | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2004-09 |
|---|---|---|---|---|---|---|---|---|
| 2. Taxation of aviation-grade kerosene | [28] | --- | 395 | 423 | 426 | 427 | 427 | 2,098 |
| 3. Dye injection equipment, security standards, and related penalties | [29] | --- | 20 | 45 | 45 | 45 | 45 | 201 |
| 4. Authority to inspect on-site records | DOE | *Negligible Revenue Effect* | | | | | | |
| 5. Registration and reporting requirements | | | | | | | | |
| a. Registration of pipeline or vessel operators required for exemption of bulk transfers to registered terminals or refineries [30] | 10/1/04 | --- | 115 | 123 | 124 | 124 | 124 | 610 |
| b. Display of registration and penalty for failure to display | [31] | *Revenue Effects Included in Line C.1. Above* | | | | | | |
| c. Penalties for failure to register and failure to report | pia 9/30/04 | --- | 2 | 2 | 2 | 2 | 2 | 10 |
| 6. Collection from customs bonds where importer not registered | fea 9/30/04 | 2 | 7 | 8 | 8 | 8 | 8 | 40 |
| 7. Modifications to heavy vehicle use tax | tpba DOE | 106 | 121 | 124 | 126 | 128 | 131 | 736 |
| 8. Modification of ultimate vendor refund claims with respect to farming | fsfnua DOE | *Negligible Revenue Effect* | | | | | | |
| 9. Dedication of revenue from certain penalties to the Highway Trust Fund | paa 10/1/04 | *No Revenue Effect* | | | | | | |
| 10. Taxable fuel refunds for certain ultimate vendors | 10/1/04 | *Negligible Revenue Effect* | | | | | | |
| 11. Two-party exchanges | DOE | *Negligible Revenue Effect* | | | | | | |
| 12. Simplify the heavy truck tire tax [32] | [33] | *Negligible Revenue Effect* | | | | | | |
| D. Treatment of nonqualified deferred compensation plans | generally ada 6/3/04 | --- | 119 | 102 | 34 | 16 | 16 | 286 |
| E. Other Revenue Provisions | | | | | | | | |
| 1. Permit private sector debt collection companies to collect tax debts [34] | DOE | --- | --- | 59 | 150 | 137 | 121 | 467 |
| 2. Modify charitable contribution rules for donations of patents and other intellectual property | cma 6/3/04 | 33 | 274 | 318 | 330 | 342 | 356 | 1,653 |
| 3. Require increased reporting for noncash charitable contributions | cma 6/3/04 | [21] | 9 | 9 | 10 | 10 | 10 | 49 |
| 4. Require qualified appraisals for charitable contributions of vehicles | cma 6/3/04 | 1 | 52 | 58 | 60 | 62 | 64 | 297 |
| 5. Extension of amortization of intangibles to acquisitions of sports franchises | aoa DOE | 5 | 52 | 88 | 71 | 37 | 22 | 275 |
| 6. Increase continuous levy for certain Federal payments | DOE | --- | 8 | 14 | 16 | 19 | 19 | 76 |
| 7. Modification of straddle rules | peo/a DOE | 7 | 21 | 24 | 27 | 31 | 34 | 144 |
| 8. Add Hepatitis A to the list of taxable vaccines [35] | [36] | 4 | 9 | 9 | 9 | 9 | 9 | 49 |
| 9. Addition of vaccines against Influenza to the list of taxable vaccines [35] | [37] | 10 | 52 | 54 | 56 | 58 | 59 | 288 |
| 10. Extension of IRS user fees (through 9/30/14) | DOE | --- | 25 | 33 | 35 | 38 | 39 | 170 |
| 11. Extend Customs User Fees: | | | | | | | | |
| a. Passenger and conveyance processing fee (through 9/30/14) [6] | DOE | --- | 105 | 331 | 348 | 365 | 383 | 1,532 |

| Provision | Effective | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2004-09 |
|---|---|---|---|---|---|---|---|---|
| b. Merchandise processing fee (through 9/30/14) [6] | DOE | --- | 679 | 1,234 | 1,308 | 1,386 | 1,470 | 6,077 |
| **Total of Revenue Provisions** | | **405** | **4,108** | **4,292** | **4,782** | **5,187** | **5,635** | **24,414** |
| **VII. Market Reforms for Tobacco Growers [6]** | **DOE** | **---** | **-1,927** | **-1,927** | **-1,927** | **-1,927** | **-1,892** | **-9,600** |
| **VIII. Trade Provisions** | | | | | | | | |
| 1. Temporary suspension of customs duty on certain ceiling fans (sunset 12/31/06) [6] | 15da DOE | -4 | -19 | -20 | -5 | --- | --- | -48 |
| 2. Temporary suspension of customs duty on certain steam generators (sunset 12/31/08) and certain reactor vessel heads used in nuclear facilities (sunset 12/31/08) [6] | 15da DOE & DOE | [4] | -1 | -1 | -3 | -3 | -1 | -8 |
| **Total of Trade Provisions** | | **-4** | **-20** | **-21** | **-8** | **-3** | **-1** | **-56** |
| **NET TOTAL** | | **1,479** | **-8,897** | **-12,684** | **-8,971** | **-3,571** | **582** | **-32,059** |

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding. Date of enactment is assumed to be July 1, 2004.

Legend for "Effective" column:

aa = acquisitions after
abiUSa = articles brought into the United States after
ada = amounts deferred after
aoa = acquisitions occurring after
apa = amounts paid after
apoamt = amounts paid or accrued more than
asbmpoia = articles sold by the manufacturer, producer, or importer after
ata = actions taken after
ataro/a = amounts treated as received on or after
bfsfa = benefits for services furnished after
cma = contributions made after
ctada = contributions, transfers, and distributions after
cyba = calendar years beginning after
da = day after
Da = distributions after
db = deferrals beginning
dma = distributions made after
Dma = deposits made after
dmi = distributions made in
do/a = disclosures on or after
dmo/a = disclosures made on or after
DOE = date of enactment
doi = date of introduction
eia = expenses incurred after
epoia = expenditures paid or incurred after
fa = formed after
fpisa = facilities placed in service after
fea = fuel entered after
fsfnua = fuels sold for nontaxable use after
fsoua = fuel sold or used after
iaeio/a = installment agreements entered into on or after
iri = interest received in
iwea = individuals who expatriate after
lf = losses for
oia = obligations issued after
paa = penalties assessed after
pada = purchases and dispositions after
pao/a = payments accrued on or after
peo/a = positions established on or after
pia = penalties imposed after
pma = payments made after
ppisa = property placed in service after
rra = risk reinsured after
sa = sales after
saptoea = stock acquired pursuant to options exercised after
sopra = sales of principal residences after
sota = sales of timber after
ta = transactions after
teia = transactions entered into after
tia = taxes imposed after
tma = transfers made after
toa = transactions occurring after
tpba = taxable periods beginning after
tra = taxes received after
trda = tax returns due after
tyba = taxable years beginning after
tyea = taxable years ending after
voa = violations occurring after
wpoifibwa = wages paid or incurred for individuals beginning work after
15da = 15 days after

*[Footnotes for the Table appear on the following page]*

**Footnotes for the Table:**

[1] Includes general transition relief in H.R. 4520, and binding contract rule from H.R. 2896, as reported by the Committee on Ways and Means.
[2] Overlap between the two rate reduction proposals (items B.1. and B.2.) is reflected in B.1.
[3] Provision is effective as if included in the amendments made by section 101 of the Job Creation and Worker Assistance Act of 2002.
[4] Loss of less than $500,000.
[5] The bill provides that the excise tax credit expires after December 31, 2010. If this bill is enacted, the Congressional Budget Office's subsequent baseline would not assume extension of the excise tax credit beyond its expiration because the requirement to assume extension of excise taxes dedicated to trust funds does not apply to excise tax credits paid from the General Fund. For purposes of this revenue estimate, therefore, it is assumed that the excise tax credit would expire as scheduled. This treatment generates changes in revenues after December 31, 2010.
[6] Estimate provided by the Congressional Budget Office. Negative numbers indicate an increase in outlays.
[7] The outlay payments for ethanol expire after December 31, 2010.
[8] Effective for the first taxable year beginning on or after date of enactment, or for the last taxable year beginning before date of enactment, at the taxpayer's election.
[9] Effective for dividends with respect to taxable years of regulated investment companies beginning after December 31, 2004.
[10] Proposal will result in a 5-year decrease in outlays of approximately $4 million from the Federal Wildlife Restoration Fund.
[11] Proposal will result in a 5-year decrease in outlays of approximately $15 million from the Aquatic Resources Trust Fund.
[12] Proposal will result in a 5-year decrease in outlays of approximately $2 million from the Aquatic Resources Trust Fund.
[13] Loss of less than $1 million.
[14] Pre-effective date excess credits carried forward to new basket that would apply under new system.
[15] Effective for taxable years of foreign corporations beginning after December 31, 2004, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.
[16] Estimate accounts for interaction with reduction to 2 foreign tax credit baskets.
[17] The "Economic Growth and Tax Relief Reconciliation Act of 2001" provides that the child tax credit and adoption tax credit are allowed for purposes of the alternative minimum tax for 2002 through 2010.
[18] The New York City Liberty Zone is defined as all business addresses located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan, New York, NY.
[19] Effective as if included in section 201 of the Victims of Terrorism Tax Relief Act of 2001.
[20] This provision will have a negligible effect on penalty excise tax receipts. However it will have an indirect effect on income tax receipts through increases in employer-contributions for health insurance and corresponding decreases in cash wages. The table shows this indirect revenue effect, which was estimated by the Congressional Budget Office.
[21] Gain of less than $500,000.
[22] Generally effective March 4, 2003.
[23] Gain of less than $1 million.
[24] Effective dates for provisions relating to reportable transactions and tax shelters: the penalty for failure to disclose reportable transactions is effective for returns and statements the due date of which is after the date of enactment; the modification to the accuracy-related penalty for listed or reportable transactions is effective for taxable years ending after the date of enactment; the tax shelter exception to confidentiality privileges is effective for communications made on or after the date of enactment; the statute of limitations for unreported listed transactions applies to all taxable years for which the statute of limitations under section 6501 has not run as of the date of enactment; the disclosure of reportable transactions by material advisors is effective for transactions with respect to which material aid, assistance or advice is provided after the date of enactment; the investor list penalty is effective for returns the due date for which is after the date of enactment; the modification of penalty for failure to maintain investor lists is effective for requests made after the date of enactment; and the penalty on promoters of tax shelters is effective for activities after the date of enactment.
[25] Effective for all taxable years, whether beginning before, on, or after the date of enactment.

*[Footnotes for the Table are continued on the following page]*

**Footnotes for the Table continued:**

[26] Effective for leases entered into on or after March 12, 2004 with exception for pending transportation leases with FTA.
[27] As to fuel taxes, effective for taxable years beginning after the date of enactment.
[28] Effective for aviation fuel removed, entered into the United States, or sold after September 30, 2004.
[29] Effective 180 days after the date on which the Secretary issues the regulations, which are required no later than 180 days after the date of enactment.
[30] Bulk transfers to unregistered parties would be taxed at the time of the transfer. The Secretary would be required to publish a list of certain registered persons beginning on July 1, 2004.
[31] The display of registration provision is effective on October 1, 2004, and the penalty provision is effective for penalties imposed after September 30, 2004.
[32] The revenue neutral tax rate on each ten pounds of tire capacity above 3,500 pounds is 9.4 cents on tires in general and 4.7 cents for biasply tires. Estimate does not include potential outlay effects, which are the responsibility of the Congressional Budget Office.
[33] Effective for sales in calendar years beginning more than 30 days after the date of enactment.
[34] Estimate is net of payments to private debt collection agents.

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2004-09 |
|---|---|---|---|---|---|---|---|
| Increases in outlays resulting from fees paid to private debt collection agents ..... | --- | --- | 19 | 50 | 45 | 40 | 154 |

[35] Estimate does not include potential outlay effects, which are the responsibility of the Congressional Budget Office.
[36] Effective for vaccines sold and used beginning on the first day of the first month beginning more than four weeks after the date of enactment.
[37] Effective for vaccines sold and used on or after the later of the first day of the first month beginning more than four weeks after the date of enactment, or the date on which the Secretary of Health and Human Services lists the vaccine in the Vaccine Injury Compensation Trust Fund.
[38] Estimate is subject to review by the Congressional Budget Office.

## B. Statement Regarding New Budget Authority and Tax Expenditures Budget Authority

In compliance with clause 3(c)(2) of rule XIII of the Rules of the House of Representatives, the Committee states that the bill involves no new or increased budget authority. The Committee further states that the revenue reducing income tax provisions involve increased tax expenditures, and the revenue increasing provisions involve reduced tax expenditures (See amounts in table in Part III.A., above.)

## C. Cost Estimate Prepared by the Congressional Budget Office

In compliance with clause 3(c)(3) of rule XIII of the Rules of the House of Representatives, requiring a cost estimate prepared by the CBO, the following statement by CBO is provided.

U.S. Congress,
Congressional Budget Office,
*Washington, DC, June 16, 2004.*

Hon. William "Bill" M. Thomas,
*Chairman, Committee on Ways and Means*
*House of Representatives, Washington, DC.*

Dear Mr. Chairman: The Congressional Budget Office has prepared the enclosed cost estimate for H.R. 4520, the American Jobs Creation Act of 2004, which was ordered reported by the House Committee on Ways and Means on June 14, 2004.

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

Douglas Holtz-Eakin,
*Director.*

Enclosure.

*H.R. 4520—American Jobs Creation Act of 2004*

Summary: H.R. 4520 would repeal the exclusion from taxation for a portion of income earned by U.S. exporters, reduce tax rates on certain corporate income, extend various expiring tax provisions, and make numerous other changes to tax law. In addition, H.R. 4520 would extend Internal Revenue Service (IRS) and customs user fees. The bill also would repeal the federal tobacco production quota program and provide direct payments through 2009 to both holders of tobacco quotas and tobacco growers. The provisions of the bill have various effective dates.

The Congressional Budget Office (CBO) and the Joint Committee on Taxation (JCT) estimate that enacting the bill would increase federal revenues by about $1.5 billion in 2004 and decrease revenues by about $29.2 billion over the 2004–2009 period and $42.2 billion over the 2004–2014 period. CBO estimates that enacting the bill would increase direct spending by $45 million in 2004 and about $4.1 billion over the 2004–2009 period, and reduce direct spending by about $5.4 billion over the 2004–2014 period. Finally, CBO estimates that implementing the bill would increase discretionary spending by $43 million over the 2004–2014 period, assuming appropriation of the necessary sums.

JCT and CBO have determined that the provisions of H.R. 4520 contain no intergovernmental mandates as defined in the Unfunded Mandates Reform Act (UMRA). The provisions of the bill that would subject vaccines for hepatitis A and influenza to taxation would increase state spending for Medicaid by about $140 million over the 2004–2009 period.

JCT has determined that H.R. 4520 contains seven private-sector mandates as defined by UMRA. CBO has reviewed the non-tax provisions and determined that the extension of the customs user fees and the extension of provisions in the Mental Health Parity Act are private-sector mandates as defined in UMRA. In aggregate, the costs of all the mandates in the bill would greatly exceed the annual threshold established by UMRA for private-sector mandates ($120 million in 2004, adjusted annually for inflation) in each of the first five years the mandates are in effect.

Estimated Cost to the Federal Government: The estimated budgetary impact of H.R. 4520 is shown in the following table. The spending impact of the legislation falls within budget functions 300 (natural resources and environment), 350 (agriculture), 550 (health), 570 (Medicare), 750 (administration of justice) and 800 (general government).

| | By fiscal year, in millions of dollars— | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
| CHANGES IN REVENUES | | | | | | | | | | | |
| Title I: Provisions relating to trade compliance and reduction in corporate income tax rates | 0 | −1,645 | −1,697 | −1,282 | −2,267 | −2,670 | −2,509 | −3,310 | −3,533 | −4,688 | −5,282 |
| Title II: Provisions relating to job creation tax incentives for manufacturers, small business, and farmers | 2,665 | −1,757 | −7,222 | −8,226 | −1,830 | 2,670 | 1,421 | 1,673 | 1,486 | 1,075 | 808 |
| Title III: Provisions relating to tax reform and simplification for United States businesses | −608 | −262 | −399 | −925 | −1,768 | −2,523 | −4,250 | −4,440 | −4,641 | −4,845 | −5,060 |
| Title IV: Extension of certain expiring provisions | −946 | −4,962 | −4,205 | −1,269 | −844 | −517 | −232 | −179 | −197 | −246 | −235 |
| Title V: Deduction of state and local general sales taxes | 0 | −2,208 | 1,373 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Title VI: Revenue provisions | 405 | 3,324 | 2,747 | 3,176 | 3,481 | 3,822 | 4,103 | 4,487 | 4,839 | 5,167 | 5,529 |
| Title VIII: Trade provisions | −4 | −19 | −21 | −8 | −3 | −1 | 0 | 0 | 0 | 0 | 0 |
| Estimated revenues | 1,512 | −7,529 | −12,170 | −8,534 | −3,231 | 781 | −1,467 | −1,769 | −2,046 | −3,537 | −4,240 |
| CHANGES IN DIRECT SPENDING | | | | | | | | | | | |
| Payments in lieu of excise tax credits for alcohol fuels: | | | | | | | | | | | |
| Estimated budget authority | 0 | 105 | 114 | 116 | 117 | 119 | 121 | 38 | 0 | 0 | 0 |
| Estimated outlays | 0 | 105 | 114 | 116 | 117 | 119 | 121 | 38 | 0 | 0 | 0 |
| Expiration of special tax treatment for ethanol: | | | | | | | | | | | |
| Estimated budget authority | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 19 | 32 | 54 | 66 |
| Estimated outlays | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 19 | 32 | 54 | 66 |
| Cover over of tax on distilled spirits: | | | | | | | | | | | |
| Estimated budget authority | 35 | 115 | 18 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Estimated outlays | 35 | 115 | 18 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Spending of conservation-relateed excise taxes: | | | | | | | | | | | |
| Estimated budget authority | 0 | 111 | 114 | 122 | 126 | 131 | 135 | 137 | 141 | 144 | 148 |
| Estimated outlays | 0 | 28 | 62 | 93 | 109 | 121 | 127 | 132 | 133 | 137 | 140 |
| IRS contracting for debt collection: | | | | | | | | | | | |
| Estimated budget authority | 0 | 0 | 19 | 50 | 45 | 40 | 37 | 37 | 37 | 37 | 37 |
| Estimated outlays | 0 | 0 | 19 | 50 | 45 | 40 | 37 | 37 | 37 | 37 | 37 |
| Taxation of hepatitis A and influenza vaccines: | | | | | | | | | | | |
| Estimated budget authority | 10 | 56 | 54 | 56 | 58 | 59 | 59 | 60 | 62 | 63 | 63 |
| Estimated outlays | 10 | 56 | 54 | 56 | 58 | 59 | 59 | 60 | 62 | 63 | 63 |
| Extension of customers user fees: | | | | | | | | | | | |
| Estimated budget authority | 0 | −784 | −1,565 | −1,656 | −1,751 | −1,893 | −1,960 | −2,074 | −2,194 | −2,321 | −2,456 |
| Estimated outlays | 0 | −784 | −1,565 | −1,656 | −1,751 | −1,893 | −1,960 | −2,074 | −2,194 | −2,321 | −2,456 |

| | By fiscal year, in millions of dollars— | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
| Market reform for tobacco growers: | | | | | | | | | | | |
| Estimated budget authority | 0 | 1,927 | 1,927 | 1,927 | 1,927 | 1,892 | 0 | 0 | 0 | 0 | 0 |
| Estimated outlays | 0 | 1,927 | 1,927 | 1,927 | 1,927 | 1,892 | 0 | 0 | 0 | 0 | 0 |
| Termination of no-net-cost tobacco price support program: | | | | | | | | | | | |
| Estimated budget authority | 0 | 500 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Estimated outlays | 0 | 500 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Total changes in direct spending: | | | | | | | | | | | |
| Estimated budget authority | 45 | 2,030 | 681 | 615 | 522 | 388 | −1,608 | −1,783 | −1,922 | −2,023 | −2,143 |
| Estimated outlays | 45 | 1,947 | 629 | 586 | 505 | 378 | −1,616 | −1,788 | −1,930 | −2,030 | −2,150 |
| CHANGES IN SPENDING SUBJECT TO APPROPRIATION | | | | | | | | | | | |
| Studies: | | | | | | | | | | | |
| Estimated authorization level | 0 | 2 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Estimated outlays | 0 | 2 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Spending from IRS user fees: | | | | | | | | | | | |
| Estimated authorization level | 0 | 3 | 3 | 4 | 4 | 4 | 4 | 4 | 5 | 5 | 5 |
| Estimated outlays | 0 | 3 | 3 | 4 | 4 | 4 | 4 | 4 | 5 | 5 | 5 |
| Total changes in discretionary spending: | | | | | | | | | | | |
| Authorization level | 0 | 5 | 3 | 4 | 4 | 4 | 4 | 4 | 5 | 5 | 5 |
| Estimated outlays | 0 | 5 | 3 | 4 | 4 | 4 | 4 | 4 | 5 | 5 | 5 |

Note.—Details may not sum to totals due to rounding.

Sources: CBO and the Joint Committee on Taxation.

Basis of Estimate: This estimate assumes the bill would be enacted in the summer of 2004.

*Revenues*

With the exception of the provisions relating to mental health parity, IRS user fees, and customs duty suspensions, JCT provided all the revenue estimates for this legislation. CBO and JCT estimate that the provisions of H.R. 4520 would increase federal revenues by about $1.5 billion in 2004 and decrease revenues by about $29.2 billion over the 2004–2009 period and $42.2 billion over the 2004–2014 period.

Title I. This title would repeal the exclusion for a portion of income earned by U.S. exporters beginning in 2005, and would provide transition relief in the first two years. JCT estimates that doing so would increase federal revenues by about $16.8 billion over the 2005–2009 period and about $49.6 billion over the 2005–2014 period. Title I also would lower the tax rate on corporations for income from certain manufacturing and other activities, and for taxable income from nonmanufacturing activities below certain amounts. JCT estimates that those tax rate reductions would decrease governmental receipts by about $26.4 billion over the 2005–2009 period and $78.5 billion over the 2005–2014 period. On net, title I would reduce revenues by about $9.6 billion over the 2005–2009 period and by $28.9 billion over the 2005–2014 period.

Title II. The provisions of title II would make numerous changes to existing tax law relating primarily to domestic business activity. On net, JCT estimates that those provisions would increase governmental receipts by about $2.7 billion in 2004, and decrease receipts by about $13.7 billion over the 2004–2009 period and $7.2 billion over the 2004–2014 period. Those provisions include, but are not limited to:

- Extending for two years the increased expensing of fixed investments by small businesses;
- Altering depreciation rules for various types of property;
- Providing relief from the alternative minimum tax;
- Restructuring tax laws for alcohol fuels; and
- Temporarily reducing the effective rate of tax on certain dividends paid by foreign corporations.

One provision would repeal the existing exemptions from the gasoline tax for alcohol fuels and replace those exemptions with an excise tax credit worth the same amount. JCT estimates that the increased compliance from doing so would increase federal revenues by $113 million over the 2005–2009 period and $220 million over the 2005–2014 period if the excise tax credit for alcohol fuels were extended beyond the provision's 2010 expiration.

Budget law (the Balanced Budget and Emergency Deficit Control Act of 1985) requires CBO to treat excise taxes dedicated to trust funds as permanent, even if they expire during the projection period. CBO's baseline includes permanent extension of the reduced rates of taxation on alcohol fuels beyond their expiration because they reduce amounts credited to the Highway Trust Fund (HTF). However, the excise tax credit for alcohol fuels, as established by the bill, would not reduce amounts credited to the HTF. Therefore, CBO and JCT do not assume the credit would be extended and estimate that repealing the existing exemptions from the gasoline tax

rate for alcohol fuels would increase governmental receipts by an additional $5.9 billion between 2011 and 2014, after the new tax credit would expire.

Title III. The provisions of title III would makes changes to tax law relating to U.S. businesses with foreign operations. Roughly half of the effect on revenues would result from altering interest expense allocation rules beginning in 2009, which JCT estimates would reduce federal revenues by about $14.4 billion over the 2009–2004 period.

Title IV. This title would temporarily extend numerous provisions set to expire under current law. Some of those provisions include the tax credit for research and experimentation expenses, the work opportunity and welfare-to-work tax credits, the treatment of nonrefundable personal credits under the individual alternative minimum tax, and parity in the application of certain limits to mental health. CBO and JCT estimate that those extensions would reduce federal revenues by $946 million in 2004, about $12.7 billion over the 2004–2009 period, and $13.8 billion over the 2004–2014 period.

Title V. Section 501 would allow taxpayers to elect to deduct state and local sales taxes in lieu of state and local income taxes. The provision would apply to tax years 2004 and 2005 and would reduce governmental receipts by an estimated $3.6 billion over fiscal years 2005 and 2006.

Title VI. All of the numerous provisions in title VI would increase revenues. CBO and JCT estimate that revenues would increase by $405 million in 2004, about $17.0 billion over the 2004–2009 period, and about $41.1 billion over the 2004–2014 period. Roughly half of the increase would come from reforming the tax treatment for leasing transactions with parties generally exempt from tax, which JCT estimates would result in additional revenues of about $19.6 billion between 2004 and 2014. Title VI also includes an extension of IRS user fees through September 30, 2014. Currently, the fees are set to expire on December 31, 2004. CBO estimates that this provision would increase revenues by $170 million over the 2005–2009 period and $396 million over the 2005–2014 period.

Title VII. Title VII would affect the Department of Agriculture's tobacco program and would have no effect on federal revenue collections.

Title VIII. Sections 801 and 802 would temporarily suspend the duties on certain ceiling fans and nuclear reactor vessel heads through December 31, 2006, and December 31, 2008, respectively. In addition, section 802 would extend the duty-free treatment of nuclear steam generators for two years beyond its current December 31, 2006, expiration date. CBO estimates that enacting those duty suspensions would reduce governmental receipts by $4 million in 2004 and $56 million over the 2004–2009 period.

*Direct spending*

Providing Direct Payments in Lieu of Excise Credits for Alcohol Fuels. Title II would provide for payments to recipients of the tax credits who have insufficient tax liability to use them otherwise. CBO estimates that outlays would increase by $571 million over the 2005–2009 period and $730 million over the 2005–2011 period.

Because these payments would replace the existing reduced tax rate on alcohol fuels, these amounts exactly equal the increase in revenues estimated for this provision.

Expiration of Special Tax Treatment for Ethanol. Replacing the gasoline tax exemption for alcohol fuels with an excise tax credit would result in increased spending for farm price and income support payments after 2010 because the former is assumed to continue after 2010, but the latter is assumed to expire. Because the alcohol in such fuels is primarily derived from corn, demand for corn rises and falls with the demand for ethanol. The higher after-tax price of alcohol fuels resulting from expiration of the tax credit in 2010 would slightly reduce demand for ethanol and corn prices relative to those projected in the CBO baseline. As a result, CBO estimates that federal spending for farm price and income support payments would increase by $171 million over the 2011–2014 period.

Cover Over of Tax on Distilled Spirits. Under current law, an excise tax of $13.50 per proof gallon is assessed on distilled spirits produced in or brought into the United States. The U.S. Treasury pays the treasuries of Puerto Rico and the Virgin Islands $10.50 per proof gallon of rum imported into the U.S. from any country or those possessions. A higher payment rate of $13.25 expired on December 31, 2003. Under H.R. 4520, the governments of Puerto Rico and the Virgin Islands would receive payments of $13.25 per proof gallon for tax assessments made between January 1, 2004, and December 31, 2005. Those payments are recorded as outlays in the budget. Based on recent tax and payment data, CBO estimates that increasing the possessions' share of the excise tax would increase direct spending by $168 million over fiscal years 2004–2006.

Spending of Conservation-Related Excise Taxes. Title VI of the bill would eliminate a requirement in current law that a portion of fuel excise taxes used by motorboats and small engines be deposited in the general fund. Those amounts would instead be deposited into the Aquatic Resources Trust Fund (ARTF). The bill also would eliminate or reduce excise taxes on certain fishing and hunting products, including archery equipment, which are deposited into either the ARTF or the Federal Aid-Wildlife Fund. Amounts in the two funds are used primarily for grants to states for the conservation of wildlife, sport fish, and coastal wetlands. CBO estimates that the net effect of enacting these two provisions would be an increase in direct spending from those funds of $1.1 billion over the 2005–2014 period.

Installment Agreements for Tax Payments. Under current law, taxpayers can elect to pay their full tax liability through installments. Section 645 would allow the IRS to enter into agreements for the partial payment of tax liabilities. That change would result in more installment agreements and additional revenue collections. The IRS charges a fee of $43 for each installment agreement, which it can spend without further appropriation. CBO estimates that allowing installment agreements providing for the partial payment of tax liabilities would increase IRS collections of installment fees by about $1 million over the 2004–2006 period. Because the IRS has the authority to retain and spend such collections without

further appropriation, the change would have no significant net budgetary impact.

IRS Contracting for Debt Collection. H.R. 4520 would allow the IRS to contract with private collection agencies (PCAs) to collect payments of tax liabilities. JCT estimates that this provision would increase revenues by about $1.4 billion over the 2006–2014 period. The IRS would be allowed to retain and spend up to 25 percent of the amount collected by the PCAs to pay for the services they provide. CBO estimates that allowing the IRS to retain and spend 25 percent of the amounts collected would increase direct spending by $339 million over the 2006–2014 period.

Taxation of Hepatitis A and Influenza Vaccines. Sections 688 and 689 would require buyers of hepatitis A and influenza vaccines to pay an excise tax on each dose purchased. Medicaid is a major purchaser of vaccines through the Vaccines for Children program, administered through the Centers for Disease Control and Prevention (CDC). Medicare is a major purchaser of the vaccines for the elderly. CBO estimates that Medicaid and Medicare pay for approximately half of the hepatitis A and influenza vaccines sold annually. Based on estimates provided by JCT, CBO expects that implementing the bill would cost the Medicaid and Medicare programs about $10 million in 2004 and $556 million over the 2004–2014 period. (Those amounts are reflected in the estimates of the revenues resulting from the bill.)

Receipts from the tax would go to the Vaccine Injury Compensation Fund (VICF), which is administered by the Health Resources and Services Administration (HRSA). The fund uses tax revenues to pay compensation to claimants injured by vaccines. Once a vaccine becomes taxable, injuries attributed to its use become compensable through this fund. Based on information provided by HRSA and CDC, we expect there would be few compensable claims related to the hepatitis A and influenza vaccines. CBO estimates that the provisions of H.R. 4520 would increase outlays from the VICF by $46 million over the 2005–2014 period. Thus, we estimate that outlays resulting from the vaccine provisions would total $10 million in 2004 and $602 million over the 2004–2014 period.

Extension of Customs User Fees. Under current law, customs user fees expire after March 1, 2005. H.R. 4520 would extend these fees through September 30, 2014. CBO estimates that this provision would increase offsetting receipts by about $18.6 billion over the 2005–2014 period.

Market Reform for Tobacco Growers. Title VII would repeal laws implemented by the Department of Agriculture (USDA) to control the supply and price of tobacco grown in the U.S. by granting individuals rights (known as quotas) to produce and market specific quantities of tobacco. Under the bill, this system of control through quotas and acreage allotments would be replaced by a series of direct federal payments to domestic tobacco growers and owners of tobacco quotas. (Because those holding tobacco quotas to produce and market tobacco can lease that right to others, the quota owners and growers may be different individuals.)

The bill would provide a direct payment to individuals of $1.49 per pound of tobacco quota owned and $0.60 per pound of tobacco quota grown for each year over the 2005–2009 period. Based on information from USDA on the volume of tobacco quotas and the use

of those quotas, CBO estimates payments under the bill would be $1,927 million a year. Because the bill would limit the new direct payments under this title to $9.6 billion, payments would have to be reduced slightly in 2009 to comply with this limitation.

In addition to the direct federal payments authorized by this title, CBO estimates that tobacco growers and buyers would be relieved of paying a federal assessment of about $500 million in 2005 due to the termination of USDA's No-Net-Cost Tobacco program. The No-Net-Cost Tobacco program is operated under current law to provide a support price (also known as loan rate) to growers of the many varieties of domestic tobacco. This program is administered through the Commodity Credit Corporation (CCC) and is separate and in addition to the tobacco quota system discussed above. Support prices for the various tobacco varieties are set by a formula specified in current law, and USDA is charged with attempting to control the supply of tobacco through quotas so that the actual market price of tobacco is at or above the support price. In the event that USDA cannot manage supply to achieve the support price in the market, growers are guaranteed the support price by USDA. Any net cost incurred by USDA to maintain the support price, however, is offset by an assessment imposed on all tobacco growers and buyers. Thus, the price support program operates at no net cost to the federal government.

Under the bill, the CCC price support for tobacco would be effective for the 2004 crop, but not for future crops. CBO expects that after enactment of this bill the market price for domestic tobacco would drop precipitously because USDA's quota and acreage allotment systems would not longer restrict the supply of tobacco. We estimate the price support program would cost the CCC about $500 million in 2005 as more growers would accept the support price for tobacco and forfeit crops from 2004 and previous years to the government. Because the bill would terminate the No-Net-Cost Tobacco program for future years' crops, USDA would have no opportunity to collect assessments from tobacco producers and buyers to offset this cost. That loss of receipts to USDA would bring the total estimated coast of enacting this title to $10.1 billion over the 2005–2009 period.

*Spending subject to appropriation*

Studies. Section 606 would require the Treasury Department to complete studies on transfer pricing rules, income tax treaties, and corporate expatriation. Assuming the appropriations of the necessary amounts, CBO estimates that performing these studies would cost about $2 million in fiscal year 2005.

Extension of IRS User Fees. Section 690 would extend the authority of the IRS to charge taxpayers fees for certain rulings, opinion letters, and determinations through September 30, 2014. The bill would authorize the IRS to retain and spend a portion of the fees collected, subject to appropriation. Based on the historical level of fees spent, CBO estimates that implementing this provision would cost $18 million over the 2005–2009 period and about $41 million over the 2005–2014 period, subject to the appropriation of the necessary amounts.

Estimated Impact on State, Local, and Tribal Governments: JCT and CBO have determined that the provisions of H.R. 4520 contain

no intergovernmental mandates as defined in UMRA. The provisions of the bill that would subject vaccines for hepatitis A and influenza to taxation would increase state spending for Medicaid by about $140 million over the 2004–2009 period.

Estimated Impact on the Private Sector: JCT and CBO have determined that H.R. 4520 contains several private-sector mandates as defined in UMRA. In aggregate, the costs of those mandates would greatly exceed the annual threshold established by UMRA for private-sector mandates ($120 million in 2004, adjusted annually for inflation) in each of the first five years the mandates are in effect.

*Tax Mandates*

JCT has determined that the following tax provisions of H.R. 4520 contain private-sector mandates as defined in UMRA: (1) repealing the exclusion for extraterritorial income; (2) altering tax law relating to reportable transactions and tax shelters; (3) reforming the tax treatment for leasing transactions with parties that are generally exempt from tax; (4) taxing aviation-grade kerosene; (5) requiring registration of pipeline and vessel operators for exemption of bulk transfers and imposing a penalty for failure to display such registration; (6) modifying the heavy vehicle use tax; and (7) modifying the charitable contribution rules for donations of patents and other intellectual property.

*Other Mandates*

CBO has determined that the non-tax provisions of the bill contain two private-sector mandates as defined in UMRA—an extension of customs user fees and an extension of provisions in the Mental Health Parity Act.

Customs User Fees. Section 691 would extend through 2014 the customs user fees that are scheduled to expire after March 1, 2005. CBO estimates that the cost of the private-sector mandate in section 691 relative to the case where the mandate is allowed to expire would be more than $70 million in fiscal year 2005 and larger in later years.

Mental Health Parity. Section 420 would extend the provisions of the Mental Health Parity Act of 1996, which expires on December 31, 2004, through the end of calendar year 2005. That act prohibits group health plans that provide both medical and surgical benefits and mental health benefits from imposing aggregate lifetime limits or annual limits for coverage of mental health benefits that are different from those used for medical and surgical benefits. CBO estimates that the cost of the private-sector mandate in section 420 relative to the case where the mandates is allowed to expire would be $39 million in fiscal year 2005 and $41 million in fiscal year 2006.

Previous CBO Estimates: On November 5, 2003, CBO transmitted a cost estimate for H.R. 2896, the American Jobs Creation Act of 2003, as ordered reported by the House Committee on Ways and Means on October 28, 2003. Many of the provisions in the two bills are different, and the assumed enactment dates differ as well. The estimated budgetary impact of the two bills reflects those differences.

On November 6, 2003, CBO transmitted a cost estimate for S. 1637, the Jumpstart Our Business Strength (JOBS) Act, as ordered reported by the Senate Committee on Finance on October 2, 2003. Again, many of the provisions in the two bills are different, and the assumed enactment dates differ as well. The estimated budgetary impact of the two bills reflects those differences.

Estimated Prepared by: Federal Revenues: Annabelle Bartsch. Federal Spending: Deborah Reis, Mark Grabowicz, David Hull, and Matthew Pickford; Margaret Nowak. Impact on State, Local and Tribal Governments: Leo Lex. Impact on the Private Sector: Paige Piper/Bach.

Estimate Approved by: G. Thomas Woodward, Assistant Director for Tax Analysis; Robert A. Sunshine, Assistant Director for Budget Analysis.

## D. Macroeconomic Impact Analysis

In compliance with clause 3(h)(2) of rule XIII of the Rules of the House of Representatives, the following statement is made by the Joint Committee on Taxation with respect to the provisions of the bill amending the Internal Revenue Code of 1986:

This bill contains provisions that have partially offsetting effects on business tax rates. Among the major provisions, it lowers marginal and average tax rates on corporate manufacturing income and some other specified corporate income. It also repeals the extraterritorial income exclusion, and includes additional provisions that increase taxes for some corporations. There are many smaller provisions affecting corporate and non-corporate businesses, some of which increase marginal or average rates, and some of which decrease rates.

The net reductions in taxation of U.S. corporations provided for in this bill will provide some incentive for additional investment in corporate capital by the corporations that experience net reductions in their corporate tax rates. However, some firms may experience an increase in taxes due to the repeal of the extraterritorial income exclusion, the limitations placed on certain leasing transactions, and other provisions. Because the rate reductions in this bill are not uniformly provided to all corporations, this proposal is likely to result in a reallocation of investment resources across different corporate sectors both within the U.S. and internationally. Provisions affecting both corporate and non-corporate businesses in small subsectors of the economy would be likely to result in the reallocation of the tax burden across these sectors, which could have positive or negative implications for economic efficiency, and hence, long-run growth. In addition, certain export activity may increase if repeal of the extraterritorial exclusion leads to the elimination of tariffs currently imposed by the European Union. Finally, the net increase in the U.S. Federal government deficit may crowd out some domestic investment in the long run.

In light of these considerations, the effects of the bill on total economic activity within the six-year budget horizon are so small as to be incalculable within the context of our current models of the aggregate economy. In order to produce a complete quantitative analysis of the effects of this proposal on specific sectors of the economy, it would be necessary to model separately the effects of the bill on the average and marginal tax rates of corporations and

other businesses of different sizes, and with varying amounts of domestic and international activities. However, current modeling capabilities do not allow for these specific changes to be explicitly modeled at this level of detail.

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

### A. Committee Oversight Findings and Recommendations

With respect to clause 3(c)(1) of rule XIII of the Rules of the House of Representatives (relating to oversight findings), the Committee advises that it was a result of the Committee's oversight review concerning the tax burden on American taxpayers that the Committee concluded that it is appropriate and timely to enact the revenue provisions included in the bill as reported.

### B. Statement of General Performance Goals and Objectives

With respect to clause 3(c)(4) of rule XIII of the Rules of the House of Representatives, the Committee advises that the bill contains no measure that authorizes funding, so no statement of general performance goals and objectives for which any measure authorizes funding is required.

### C. Constitutional Authority Statement

With respect to clause 3(d)(1) of the rule XIII 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 8 ("The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises . . ."), 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 (Pub. L. No. 104–4).

The Committee has determined that the bill contains seven Federal mandates on the private sector: (1) the provision to repeal the exclusion for extraterritorial income; (2) the provision relating to reportable transactions and tax shelters; (3) the provision relating to the reform of the tax treatment for leasing transactions with tax-indifferent parties; (4) the provision relating to the taxation of aviation grade kerosene; (5) the provision requiring registration of pipeline and vessel operators for exemption of bulk transfers and imposing a penalty for failure to display such registration; (6) the provision to modify the heavy vehicle use tax; and (7) the provision to modify the charitable contribution rules for donations of patents and other intellectual property. The costs required to comply with each Federal private sector mandate generally are no greater than the aggregate estimated budget effects of the provision. Benefits from the provision include improved administration of the tax laws and a more accurate measurement of income for Federal tax purposes.

The Committee has determined that the bill does not impose a Federal intergovernmental mandate on State, local, or tribal governments.

### E. Applicability of House Rule XXI 5(b)

Rule XXI 5(b) of the Rules of the House of Representatives provides, in part, that "A bill or joint resolution, amendment, or conference report carrying a Federal income tax rate increase may not be considered as passed or agreed to unless so determined by a vote of not less than three-fifths of the Members voting, a quorum being present." 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 increases within the meaning of the rule.

### F. Tax Complexity Analysis

Section 4022(b) of the Internal Revenue Service Reform and Restructuring Act of 1998 (the "IRS Reform Act") requires the Joint Committee on Taxation (in consultation with the Internal Revenue Service and the Department of the Treasury) to provide a tax complexity analysis. The complexity analysis is required for all legislation reported by the House Committee on Ways and Means, the Senate Committee on Finance, or any committee of conference if the legislation includes a provision that directly or indirectly amends the Internal Revenue Code and has widespread applicability to individuals or small businesses.

The staff of the Joint Committee on Taxation has determined that a complexity analysis is not required under section 4022(b) of the IRS Reform Act because the bill contains no provisions that amend the Internal Revenue Code and that have "widespread applicability" to individuals or small businesses.

## V. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

Legislative Counsel has not prepared a Ramseyer at the time of the filing of this report (June 16, 2004).

## VI. DISSENTING AND ADDITIONAL VIEWS

### DISSENTING VIEWS

The bill reported by the Committee is the fourth legislative proposal from Chairman Thomas addressing the World Trade Organization ruling concerning the FSC/ETI export related tax benefits. The only consistent theme in all of those proposals has been the inclusion of tax incentives for companies to move operations and jobs offshore.

- The first proposal, H.R. 5095 from the 107th Congress, was introduced almost two years ago. It included large domestic tax increases to finance $86 billion of overseas tax benefits. As a result, the bill was never scheduled for markup.
- The second bill, H.R. 2896, was introduced a year later on July 25, 2003. The fiscal cost of that bill ($128 billion over 10 years) and the lack of any general domestic replacement for the FSC/ETI benefit meant that there were not sufficient votes in the Committee to report the legislation in its introduced form.
- Chairman Thomas' third proposal came when he announced his substitute in connection with the markup of H.R. 2896 on October 28, 2003. For the first time, the Chairman was willing to include elements of the bipartisan Crane-Rangel-Manzullo-Levin bill. Those modifications were sufficient to allow the bill to be reported on a straight party-line vote. However, the bill never was scheduled for Floor consideration, presumably because it did not have sufficient votes.
- Finally, the Chairman has brought forth a fourth version, essentially unchanged in its basic structure from the bill reported last year. The major significant change is the addition of extraneous items designed to buy votes.

At no time during the almost 2-year period that began with the introduction of his first bill did the Chairman attempt to bring the Committee on Ways and Means together on a bipartisan basis to reach a consensus on how to respond to the European challenge to our FSC/ETI program. The 2-year delay was not necessary and has resulted in U.S. products being subjected to European retaliatory tariffs. Congressmen Crane, Rangel, Manzullo, and Levin introduced legislation during that period, which demonstrated that a bipartisan consensus could have been reached on this issue, avoiding trade sanctions.

Now the Chairman has abandoned any pretext of justifying his approach to the FSC/ETI issue on policy grounds. He is adopting the crude and perhaps effective approach of simply buying the votes with unrelated, and, often, special interest provisions, many of which have never borne the scrutiny of a Committee hearing or markup.

We hope that those who are being offered blandishments to support the Chairman's bill will consider the following:

1. First, the blandishments being offered can quickly disappear in conference. There will be extraordinary pressure to shrink the size of the bill, because the Senate will insist that the bill be revenue neutral. Few should be surprised if the conference report reflects the priorities of the Chairman and does not include many of the ornaments being attached to the bill in order to buy votes.

2. Second, Members should not just focus on the blandishments being offered to buy votes. They should examine the rest of the Committee bill and make sure they would be comfortable defending its provisions. The Committee bill provides tremendous incentives for companies to move jobs offshore. Even its "domestic rate cut" will reward companies that purchase cheap, imported parts or outsource services overseas. It permits companies to put profits above patriotism and move their corporate charters offshore for tax avoidance.

3. Third, while this bill includes some offsets, it still increases deficits over the next ten years by $34 billion. This number is deceptive, however, because the delayed effective dates and other accounting gimmicks indicate the long-term effect on the national debt will be much greater. In addition, some of the offsets, like authorizing the IRS to outsource collections to private debt collectors, are simply bad policy. It is bad enough to be promoting the offshore outsourcing of American jobs through enhanced corporate tax subsidies. It is totally indefensible to pay for such subsidies by increasing deficits that have already proven a drag on our economy, and will eventually have to be paid through higher taxes on future generations of Americans.

4. Finally, Members should understand that farmers and other small businesses will be large losers if the Committee bill prevails. Both corporate and noncorporate taxpayers are eligible for export-related benefits under current law. As a result, the bill passed by the Senate and the amendment offered by Congressman Rangel provide across-the-board rate reductions for all domestic producers, whether organized as taxable corporations or as subchapter S corporations, partnerships, or sole proprietorships. Only the Committee bill limits the general rate reductions to corporations and it provides the largest rate reduction for the biggest corporations.

Following is an elaboration of some of the provisions in the Committee bill that make it a bad choice:

## COMMITTEE BILL PROVIDES INCREASED INCENTIVES FOR MOVING JOBS OFFSHORE

### PRESENT LAW

A recent study published by the American Enterprise Institute noted that our current international tax rules already provide significant incentives for U.S. companies to move jobs and operations offshore. That study concluded that federal tax receipts would rise by $7 billion per year if the United States provided a tax exemption for the overseas business income of our multinationals.

The Joint Committee on Taxation reached a similar conclusion in a preliminary revenue estimate that indicated that such a territorial system would raise approximately $60 billion over 10 years.

Any doubt over the accuracy of those estimates was removed when the National Foreign Trade Council (a group of large, U.S.-based multinationals) issued a press report stating that moving to a territorial system "would put U.S. companies at a significant disadvantage in the global market."

These facts suggest that our current system, in many circumstances, provides a negative tax overseas, i.e., benefits greater than the exemption under a territorial system. The fact that U.S. multinationals oppose adoption of a territorial system is stark evidence of the liberal nature of our system.

The Congressional Research Service concluded that our current international tax rules provide incentives for U.S. firms to move overseas. In a recent report, they stated—"We begin by looking at the incentive effects of the current U.S.-international system, with the deferral system and indirect foreign tax credit described above. Economic theory is relatively clear on the basic incentive impact of the system: it encourages U.S. firms to invest more capital than they otherwise would in overseas locations where local taxes are low. * * * Deferral poses an incentive for U.S. firms to invest abroad in countries with low tax rates over investment in the United States."

COMMITTEE BILL

The Committee reported bill provides a dramatic increase in the incentives to more offshore. Moreover, the bill deliberately attempts to hide the size of the tax cuts on offshore operations through delayed effective dates.

When the bill is fully effective, the annual cost of the international benefits is approximately $5 billion. The Committee bill almost doubles the size of the negative tax overseas.

Though billed as reform, a number of the international provisions do not constitute reform, they include some very large overseas benefits and a larger number of small special interest provisions.

The Committee bill provides some new, significant tax benefits that would encourage companies to move jobs and operations offshore. Following are examples.

*A. Increased Cross-Crediting*

The Committee bill (sec. 303) reduces the number of foreign tax credit baskets to two. This may seem like a technical change but it would cost over $1 billion per year, and increase incentives to move offshore.

The provision repeals current law limitations on cross-crediting, i.e., using taxes paid in one country at rates exceeding U.S. rates to offset U.S. tax on income from other countries.

The provision effectively subsidizes high-tax foreign countries. Companies could locate in a high-tax country and have the United States government bear the cost of that country's tax above the U.S. rate if they also have income in low-tax countries.

Companies would receive no tax advantage from locating in the United States rather than a higher tax country overseas, since they could use the higher foreign taxes to reduce tax on other income.

Also, the provision creates incentives to shift operations from the United States into low-tax jurisdictions to take advantage of the cross-crediting.

*B. Liberalized Deferral*

The Committee bill (sec. 311) contains modifications to subpart F (anti-deferral regime) that would also increase incentives to move jobs offshore.

The modifications would permit amounts earned by one offshore subsidiary to be reinvested in any other location (other than the United States) without tax.

The modifications also would permit U.S. companies to avoid tax on their income from operations in developed countries through earnings stripping transactions. This would provide a substantial incentive to move offshore; companies could get the benefits of operating in a developed country without tax.

If U.S. companies can get the benefits of low tax rates for investments located in high-tax countries, one economist suggested that the United States is "likely to lose capital and jobs, as well as all of the taxable profits associated with them."

The Committee bill also includes a series of narrowly targeted benefits for companies operating overseas, such as benefits for overseas commodity traders, companies leasing aircraft overseas, and security dealers.

THOMAS BILL'S DOMESTIC MANUFACTURING BENEFIT IS DEEPLY FLAWED

*1. Small corporations and unincorporated small businesses need not apply*

The bipartisan H.R. 1769 would provide an effective 10% across the board rate reduction for *all corporations*, regardless of size, engaged in domestic manufacturing. The Senate bill extends the rate reduction to businesses, like subchapter S corporations, partnerships, farms, and other proprietorships not subject to the corporate tax. Extension of the rate cut to those businesses was among the improvements to H.R. 1769 that were included in the amendment that Congressman Rangel offered in the Committee.

In contrast, Chairman Thomas' "manufacturing rate cut" provides its largest benefit to large corporations and little or no benefit to other corporations or businesses. According to the nonpartisan Joint Committee on Taxation, 82% of all profitable corporations do not have incomes large enough to benefit from the rate adjustment contained in the Committee bill. The Committee rate reduction does not apply to businesses that are not taxed as corporations. Therefore, all subchapter S corporations, partnerships, farms and other proprietorships engaged in manufacturing activities will receive no rate adjustment whatsoever from the Committee bill.

Again, we would like to emphasize that 82% of all profitable corporations will receive no tax benefit from the Committee bill because they are too small. No business engaged in manufacturing,

but not organized as a taxable corporation, will receive any benefit. All of those businesses, regardless of size or organizational structure, would receive a tax reduction under Congressman Rangel's amendment.

*2. Alternative minimum tax (AMT) clawback*

Republicans have often described the corporate alternative minimum tax as the "anti-manufacturing tax." that rhetoric is fairly hypocritical when one views the substance of the Committee's manufacturing tax cut.

The Committee bill reduces the regular tax on manufacturing income but not the minimum tax. As a result, all corporations affected by the minimum tax under current law will receive no benefit from the rate reduction contained in the Committee bill. Other manufacturers may find that the name of the tax they pay has changed, but the amount stays the same. The Committee bill promises a three-point rate reduction, but some corporations will find that much, if not all, of their rate reduction is taken back by the corporate minimum tax. Capital-intensive manufacturers will be among those most adversely by this aspect of the Committee bill.

In contrast, the Senate bill and the amendment offered by Congressman Rangel provides an effective 10% across the board reduction in both corporate and minimum tax rates. No portion of the benefit promised in those proposals will be clawed back through the minimum tax.

*3. Tax incentives for outsourcing labor force and parts*

The Committee bill will provide substantial tax benefits for the income of domestic companies that is attributable to outsourcing technical and administrative services overseas, or is that is attributable to cost-savings from using cheap imported parts. If a domestic manufacturer is able to reduce its cost by conducting research, testing, computer programming, or other service functions overseas, it will receive a rate reduction for the income resulting from those cost savings. If a domestic manufacturer assembles a product in the United States using cheap imported parts, it will receive a rate reduction for the income resulting from the cost-savings. Effectively, even the portion of the Committee bill which is advertised as helping U.S. manufacturers provides incentives for outsourcing overseas.

Last Thursday, The Wall Street Journal published an article which gives an idea of how large the potential loophole in the Committee bill may be. It described how auto manufacturers were forcing their suppliers to outsource parts manufacturing overseas. All of the cost savings from that offshoring will receive tax benefits under the Committee bill.

This aspect of the Committee bill is deliberate, not accidental. The provision passed by the Senate and the amendment offered by Mr. Rangel, both contain provisions designed to ensure that the "U.S. manufacturing benefit" only be allowed for income earned from productive activities in the United States. Both of those proposals explicitly make clear that income resulting from offshoring will not be eligible for the new rate reduction. It is difficult to un-

derstand what could motivate Republican members of this Committee to endorse a proposal incentivizing offshoring.

Previously, most of the jobs moved by U.S. companies overseas were manufacturing jobs. Now, increasingly, we are seeing U.S. companies moving technical work, computer programming, call centers, and other service jobs to take advantage of cheap labor rates overseas. That trend will be accelerated by the tax benefits provided by the Committee bill for income resulting from the cost saving of hiring cheaper foreign labor.

For example, if a software company hires foreign computer programmers to produce parts of its software because of lower wage rates overseas, it will receive a rate reduction for the cost saving so long as the final computer program is assembled in the United States. Manufacturers that move call centers or technical assistance services overseas similarly will get rate reductions for the income derived by hiring cheap, foreign labor. Importers of cheap foreign goods will receive benefits if there is some assembly here.

### PATRIOTISM JUST HAS TO TAKE A BACK SEAT TO PROFITS

A spokesperson for a major accounting firm which was promoting the tax avoidance device of moving the corporate charter offshore was asked whether there was any downside to these transactions. The response was stark. The spokesperson suggested that the 9/11 tragedies placed an emphasis on patriotism. That concern was dismissed with the statement that the profits from the transaction were so large that "the patriotism issue needs to take a back seat."

The Thomas bill is totally consistent with the view expressed by that person. It contains no meaningful restrictions on the ability of corporations to move their corporate charters offshore for tax avoidance purposes. The Bush Treasury Department representative at the markup acknowledged that the Committee bill did little to stop these transactions. Remarkably, he supported the bill anyway, arguing that the Bush Administration opposes "putting up walls" that prevent businesses from moving their corporate charters offshore.

### COMMITTEE BILL IMPOSES COSTS ON STATE AND LOCAL GOVERNMENTS TO FUND CORPORATE TAX BENEFITS

Increasingly, the Bush Administration, and the Republican Congress, have increased the burdens on State and local governments. They have imposed new mandates without providing needed resources. Some of the tax policies promoted by the Bush Administration have had the indirect impact of increasing the burden of State and local taxes.

Budget crises faced by State and local governments have caused some of them to engage in leasing transactions from which they receive some monetary benefits. We recognize that many of these transactions are abusive, and that the amount received by the State and local government is a relatively small portion of the overall federal revenue loss. Therefore, we would support reform in this area, but cannot support the Committee bill that merely increases the burden on State and local governments, and makes no attempt to replace the benefit.

IRS USE OF PRIVATE COLLECTORS FOR FEDERAL TAX DEBTS

The bill's provision to "privatize" IRS debt collection should be an affront to taxpayers nationwide. Federal tax collection is and should continue to be the job of the IRS and the Department of Treasury—it is an inherently governmental function. The collection of Federal taxes should not be a profitable business venture for corporate America looking to expand their debt collection market share. The very notion of unleashing a small army of bill collectors on the taxpayers of this Nation should give major pause to everyone.

The Committee bill specifically rewards private debt collectors up to 25% of amounts collected from taxpayers. It is offensive and a failure of responsibility for the Committee to give companies and their employees—who are not directly accountable to the Treasury Department Secretary and IRS Commissioner—"a bounty" for getting money from taxpayers. The IRS's earlier project to use private debt collectors resulted in numerous violations of the Fair Debt Collection Act and was abandoned, in large part, because the companies were not able to collect taxes from the taxpayers assigned to them—cases having large and old tax delinquencies. Now, the Treasury Department plans to given these firms small and recent cases so they can make profit. This "cherry picking" means that private tax collectors will be able to work on average taxpayer cases—those who, in fact, filed a return in 2001, 2002 or 2003 and were unable to enclose a balance due check of $40–$600.

Clearly, the IRS could do this collection work if it had more resources. The Republican Leadership just plain refuses to give the IRS the resources it needs and wants to do its job of properly administering our tax laws. There is no question that the IRS could efficiently and effectively collect additional taxes due and do so for about 3–5% of the amount collected. The notice and letter machines, the telephone lines, the know-how, the entire process is there and ready to go at the IRS. All that is needed are staff and resources to do the work under the existing system. Why would we pay someone 25% of a $1,000 tax bill for making a phone call or sending a letter to a taxpayer, when the IRS could send that some letter or make that same phone call at little cost?

The proposal is unfair, inefficient, and a threat to taxpayer confidentiality. The fact that the provision specifically prevents a lawsuit against the United States in the event a taxpayer is abused by a tax collection company clearly shows that the Committee's plan does include taking responsibility for how the private debt collection plan turns out.

## ADDITIONAL VIEWS OF REPRESENTATIVE EARL POMEROY

The road to reporting H.R. 4520 has been long and tortured. It began with various legislative efforts to assist domestic manufacturers, including the Domestic International Sales Corporation (DISC) provisions, Foreign Sales Corporation (FSC) provisions, and ultimately the provisions of the Extraterritorial Income Exclusion (ETI) Act. Unfortunately, the World Trade Organization has found ETI unlawful and authorized billions of dollars of sanctions until such time as ETI is repealed.

Presently, our companies and products are facing tariffs of 8 percent, with this rising by 1 percentage point a month until repeal is affected. This situation is untenable and we must therefore pass legislation that at a minimum repeals ETI. I also believe that it is appropriate to find a WTO-compliant way of providing an equivalent benefit for our domestic manufacturers. This was the purpose behind the bipartisan Crane-Rangel proposal, which I supported.

Ultimately, I find myself unable to wholly support either the underlying bill or the substitute amendment that was offered. While my concerns are many, I am most concerned about the fact that the Chairman's bill has chosen to exclude non-C corporation taxpayers from the tax reductions that are provided. Small businesses, whether they are S corporations or sole proprietorships, farmers or other small manufacturers, should not be excluded from the effort to solidify our domestic production activities.

Similarly, while I am concerned that the Chairman's mark has a minimum cost of $35 billion dollars, and likely much more once the various gimmicks are accounted for, I am equally concerned that in the rush to find offsets, we are continuing a trend that has been underway for the last several years, that being shifting our tax burdens from the federal level to our state and local governments. Specifically, I am concerned that efforts to curb leasing transactions, which are most often used by state and local governmental entities, are being undertaken without ensuring that there is a viable financing alternative left to fund infrastructure projects at our universities, water treatment facilities, and transit systems.

I support the vast majority of the provisions contained in the substitute amendment. Unfortunately, the substitute has, I believe, itself overreached with its provisions on corporate inversion. I do not support the actions of those companies that have chosen to invert. I believe, however, that the inversion provisions in the substitute amendment would have an unfair retroactive effect. The substitute would reach back and punish those companies who legally, though still unwisely in my view, inverted before March of 2002, when Congress first gave notice that it might change the applicable tax laws.

The inversions that were finalized before 2002 were approved by corporate shareholders that paid tens of millions of dollars in U.S.

taxes as a result of the transactions. The substitute does not address how to undo this. Additionally, had the inverting corporations been given notice of impending Congressional action, they might not have inverted and may have made other decisions regarding their corporate structures and business activities. This logic is supported by the lack of companies inverting after March 2002, once Congress gave fair warning. Making a retroactive change going back to before March 2002 could threaten over 2,000 manufacturing jobs in North Dakota and likely even more across the rest of the country. Therefore, despite my concerns about the act of inverting, I cannot support the manner in which the substitute addresses the issue.

I am also concerned that neither of the bills before the committee addressed the issue of energy tax incentives. In its bill, the Senate included a thoughtful array of energy tax provisions, including important provisions relating to the wind energy tax credit and ethanol and biodiesel. As with the proposed tax rate reductions for our domestic manufacturers, these energy provisions can play a significant role in employing Americans while also reducing our energy dependence. I support these measures and I am hopeful that the Senate's energy provisions will be retained in conference.

I remain hopeful that we can quickly pass legislation repealing ETI and that in conference a fair resolution will be made relating to the scope of any tax benefits and the handling of leasing transactions and corporate inverters.

EARL POMEROY.

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