108th Congress) (Report
1st Session) **SENATE** (108-

ENERGY TAX INCENTIVES ACT OF 2003

May __, 2003.--Ordered to be printed

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

R E P O R T

[To accompany S. ___]

[Including cost estimate of the Congressional Budget Office]

The Committee on Finance reported an original bill (S. ____) to amend the Internal Revenue Code of 1986 to provide energy tax incentives, and for other purposes, having considered the same, reports favorably thereon and recommends that the bill do pass.

CONTENTS

Page

Page

I. LEGISLATIVE BACKGROUND

The Senate Committee on Finance marked up an original bill, S. ____ (the "Energy Tax Incentives Act of 2003"), on April 2, 2003, and, with a quorum present, ordered the bill favorably reported by a voice vote on that date.

TITLE I – RENEWABLE ELECTRICITY PRODUCTION TAX CREDIT

A. Extension and Modification of the Section 45 Electricity Production Credit (sec. 101 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 was 1.8 cents per kilowatt hour for 2002. 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 United States electric grid. The Committee also believes it is important to extend the placed in service date for closed-loop biomass facilities to give those potential fuel sources an opportunity in the market place. The Committee also believes it is appropriate to include in qualifying facilities those facilities that co-fire closed-loop biomass fuels with coal, with other biomass, or with coal and other biomass.

Based on the success of the section 45 credit in the development of wind power as an alternative source of electricity generation, the committee further believes the country will benefit from the expansion of the production credit to certain other "environmentally friendly" sources of electricity generation such as open-loop biomass and agricultural waste nutrients, geothermal power, solar power, biosolids and sludge, small irrigation systems, and trash combustion. While not all of these additional facilities are pollution free, they do address environmental concerns related to waste disposal. In addition, these potential power sources further diversify the nation's energy supply.

In the current electricity market, the Committee believes that a subsidy via a tax credit of 1.8 cents per kilowatt-hour should provide sufficient incentive to investors to enter the market with alternative sources of electricity. Therefore the Committee believes indexing of the credit amounts for years after 2003 is unwarranted.

Because tax-exempt persons such as public power systems and cooperatives provide a significant percentage of electricity in the United States, the Committee believes it is important to provide the incentive for production from renewable resources to these persons in addition to taxable persons.

Lastly, the Committee believes that certain pre-existing facilities should qualify for the section 45 production credit, albeit at a reduced rate. These facilities previously received explicit subsidies, or implicit subsidies provided through rate regulation. In a deregulated electricity market, these facilities, and the environmental benefits they yield, may be uneconomic without additional economic incentive. The Committee believes the benefits provided by such existing facilities warrant their inclusion in the section 45 production credit.

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) and before January 1, 2007.

The provision provides that, for facilities placed in service after the date of enactment, the amount of the credit will be 1.8 cents per kilowatt hour with no adjustment for inflation for production in years after 2003.

The provision also defines six new qualifying energy resources: biomass (including agricultural livestock waste nutrients), geothermal energy, solar energy, small irrigation power, biosolids and sludge, and municipal solid waste.

Qualifying biomass facilities are facilities using biomass to produce electricity that are placed in service prior to January 1, 2005. Qualifying agricultural livestock waste nutrient facilities are facilities using agricultural livestock waste nutrients to produce electricity that are placed in service after the date of enactment and before January 1, 2007.

For a facility placed in service after the date of enactment, the ten-year credit period commences when the facility is placed in service. In the case of biomass facility originally placed in service before the date of enactment, the ten-year credit period is reduced to a five-year period and commences after December 31, 2003 and the otherwise allowable 1.8 cent-per-kilowatt-hour credit is reduced to a 1.2 cent-per-kilowatt-hour credit.[1]

The provision modifies present law to provide that qualifying closed-loop biomass facilities include any facility originally placed in service before December 31, 1992 and modified to use closed-loop biomass to co-fire with coal, to co-fire with other biomass, or to co-fire with coal and other biomass, before January 1, 2007. The taxpayer may claim credit for electricity produced at such qualifying facilities with the credit amount equal to the otherwise allowable credit multiplied by the ratio of the thermal content of the closed loop biomass fuel burned in the facility to the thermal content of all fuels burned in the facility.

Qualifying geothermal energy facilities are facilities using geothermal deposits to produce electricity that are placed in service after the date of enactment and before January 1, 2007. Qualifying solar energy facilities are facilities using solar energy to generate electricity that are placed in service after the date of enactment and before January 1, 2007. In the case of qualifying geothermal energy facilities and qualifying solar energy facilities, taxpayers may claim the otherwise allowable credit for the five-year period commencing when the facility is placed service.

A qualified small irrigation power facility is a facility originally placed in service after the date of enactment and before January 1, 2007. A small irrigation power facility is a facility that generates electric power through an irrigation system canal or ditch without any dam or impoundment of water. The installed capacity of a qualified facility is less than five megawatts.

A qualified biosolids and sludge facility is a facility originally placed in service after the date of enactment and before January 1, 2007. A biosolids and sludge facility is a facility that uses the waste heat from the incineration of biosolids and sludge to produce electricity. For example, if the taxpayer conveys biosolids and sludge into a glass furnace for the purpose of stabilizing the inorganic contents of the biosolids and sludge in an amorphous glass matrix (and potentially selling the resulting glass aggregates), and the taxpayer uses the waste heat from the glass furnace to generate steam to power a turbine and produce electricity, the electricity produced would be from a qualified biosolids and sludge facility. In addition, a qualifying biosolids and sludge facility is a facility for which the taxpayer has not claimed credit as a combined heat and power system property as defined elsewhere in this bill.

Municipal solid waste facilities (or units) are facilities (or units) that burn municipal solid waste (garbage) to produce steam to drive a turbine for the production of electricity. Qualifying municipal solid waste facilities (or units) include facilities (or units[2]) placed in service after the

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[1] As is the case for the 1.8 cents-per-kilowatt-hour credit, the 1.2 cents-per-kiowatt-hour credit is not indexed for future inflation.

[2] For this purpose a unit eligible under the bill would comprise a new burner, boiler and turbine system installed on the site of an existing municipal solid waste facility.

date of enactment and before January 1, 2007. In the case of qualifying municipal solid waste facilities (or units), taxpayers may claim the otherwise allowable credit for the five-year period commencing when the facility (or unit) is placed service.[3]

Biomass is defined as any solid, nonhazardous, cellulosic waste material which is segregated from other waste materials and which is derived from any of forest-related resources, solid wood waste materials, or agricultural sources. Eligible forest-related resources are mill and harvesting residues, precommercial thinnings, slash, and brush. Solid wood waste materials include waste pallets, crates, dunnage, manufacturing and construction wood wastes (other than pressure-treated, chemically-treated, or painted wood wastes), and landscape or right-of-way tree trimmings. Agricultural sources include orchard tree crops, vineyard, grain, legumes, sugar, and other crop by-products or residues. However, qualifying biomass for purposes of this provision does not include municipal solid waste (garbage), gas derived from biodegradation of solid waste, or paper that is commonly recycled. Agricultural waste nutrients are defined as livestock manure and litter, including bedding material for the disposition of manure. Agricultural livestock comprise bovine, swine, poultry,[4] and sheep among others.

Geothermal energy is energy derived from a geothermal deposit which is a geothermal reservoir consisting of natural heat which is stored in rocks or in an aqueous liquid or vapor (whether or not under pressure).

Biosolids and sludge are the residue or solids removed during the treatment of commercial, industrial, or municipal wastewater.

Municipal solid waste is "solid waste" as defined in section 2(27) of the Solid Waste Disposal Act.

The provision provides that certain persons (public power systems, electric cooperatives, rural electric cooperatives, and Indian tribes) may sell, trade, or assign to any taxpayer any credits that would otherwise be allowable to that person, if that person were a taxpayer, for production of electricity from a qualified facility owned by such person. However, any credit sold, traded, or assigned may only be sold, traded, or assigned once. Subsequent transfers are not permitted. In addition, any credits that would otherwise be allowable to such person, to the extent provided by the Administrator of the Rural Electrification Administration, may be applied

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[3] No credit is permitted during the taxable year if, during any portion of the taxable year, there is a certification in effect by the Administrator of the Environmental Protection Agency that the facility was permitted to operate in a manner inconsistent with section 4003(d) of the Solid Waste Disposal Act.

[4] The provision deletes poultry litter as a separate qualifying facility for facilities placed in service after the effective date. Poultry litter facilities remain qualifying facilities as agricultural waste nutrient facilities. Any poultry litter facility placed in service on or prior to the date of enactment is unaffected by the modifications made by this provision. For example, the value of the credit that may be claimed for production from such a facility would continue to be indexed for inflation.

as a prepayment to certain loans or obligations undertaken by such person under the Rural Electrification Act of 1936.

In the case of qualifying open-loop biomass facilities, qualifying closed-loop biomass facilities modified to use closed-loop biomass to co-fire with coal, with other biomass, or with coal and other biomass, and qualifying municipal solid waste facilities, the provision permits a lessee or operator to claim the credit in lieu of the owner of the facilities.

Lastly, the provision repeals the present-law reduction in allowable credit for facilities financed with tax-exempt bonds or with certain loans received under the Rural Electrification Act of 1936. In the case of qualifying closed-loop biomass facilities modified to use closed-loop biomass to co-fire with coal, with other biomass, or with coal and other biomass, the provision repeals the present-law reduction in allowable credit for facilities that receive any subsidy.

Effective Date

The provision generally is effective for electricity produced and sold from qualifying facilities after the date of enactment. For electricity produced from qualifying open-loop biomass facilities originally placed in service prior to the date of enactment, the provision is effective January 1, 2004.

TITLE II – ALTERNATIVE MOTOR VEHICLES AND FUEL INCENTIVES

A. Modifications and Extensions of Provisions Relating to Electric Vehicles, Clean-Fuel Vehicles, and Clean-Fuel Vehicle Refueling Property (secs. 201, 202, 203, and 204 of the bill and secs. 30 and 179A and new secs. 30B, 30C, and 40A 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 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.

Clean-fuel vehicle refueling property

Clean-fuel vehicle refueling property may be expensed and deducted when such property is placed in service (sec. 179A). Clean-fuel vehicle refueling property comprises property for the storage or dispensing of a clean-burning fuel, if the storage or dispensing is the point at which the fuel is delivered into the fuel tank of a motor vehicle. Clean-fuel vehicle refueling property also includes property for the recharging of electric vehicles, but only if the property is located at a point where the electric vehicle is recharged. Up to $100,000 of such property at each location owned by the taxpayer may be expensed with respect to that location. The deduction is unavailable for costs incurred after December 31, 2006.

Reasons for Change

The Committee believes that further investments in alternative fuel and advanced technology vehicles are necessary to transform automotive transportation in the United States to be cleaner, more fuel efficient, and less reliant on petroleum fuels.

Tax benefits provided directly to the consumer to lower the cost of new technology and alternative-fueled vehicles can help lower consumer resistance to these technologies by making the vehicles more price competitive with purely petroleum-based fuel vehicles and creating increased demand for manufacturers to produce the technologies. The eventual goal is mass production and mass-market acceptance of new technology vehicles. The Committee recognizes that creating a number of different credits tailored to each different automotive technology adds complexity to the Internal Revenue Code, but no one technology has established that it alone provides the solution. Therefore, it is appropriate to provide tax benefits tailored to specific vehicle technologies, as long as the vehicle's engine technology directly replaces gasoline and diesel fuel with an alternative energy source.

The Committee expects that hybrid motor vehicles and dedicated alternative fuel vehicles are the near-term technological advancement that will replace gasoline- and diesel-burning engines with alternative-powered engines, and electrical and fuel cell vehicles will be the long-term technological advancement.

Applying these technologies to medium and heavy-duty trucks and buses is also important for transforming the transportation sector to a cleaner, more fuel-efficient sector less reliant on petroleum-based fuels. Therefore, it is appropriate to use tax incentives to encourage the introduction of advanced vehicle technologies in large trucks and buses.

In addition, because new vehicle technologies require new fuels and infrastructure to deliver those fuels, investments in new technology automobiles alone are not sufficient to transform the market to accept these vehicles. Therefore, substantial investments in new refueling stations and new fuels are also necessary to make alternative vehicle technologies feasible.

Explanation of Provision

Alternative motor vehicle credits

The bill provides a credit for the purchase of a new qualified fuel cell motor vehicle, a new qualified hybrid motor vehicle, and a new qualified alternative fuel motor vehicle. In general the provision provides that the buyer claims the credit, unless the buyer is a tax-exempt entity in which case the seller or lessor of the vehicle may claim the credit. The taxpayer may carry forward unused credits for 20 years or carry unused credits back for three years (but not to any taxable year beginning before the date of enactment). Qualified vehicles are vehicles placed in service before 2007 (2012 in the case of fuel cell vehicles). Any deduction otherwise allowable under sec. 179A is reduced by the amount of credit allowable.

Fuel cell vehicles

A qualifying fuel cell vehicle is a motor vehicle that is propelled by power derived from one or more cells which convert chemical energy directly into electricity by combining oxygen with hydrogen fuel which is stored on board the vehicle and may or may not require reformation prior to use. The amount of credit for the purchase of a fuel cell vehicle is determined by a base credit amount that depends upon the weight class of the vehicle and, in the case of automobiles or light trucks, an additional credit amount that depends upon the rated fuel economy of the vehicle compared to a base fuel economy. For these purposes the base fuel economy is the 2002 model year city fuel economy rating for vehicles of various weight classes (see below). Table 1 below, shows the base credit amounts.

Table 1.–Base Credit Amount for Fuel Cell Vehicles

Vehicle Gross Weight Rating in Pounds	Credit Amount
vehicle ≤ 8,500	$4,000
8,500 < vehicle ≤ 14,000..................................	$10,000
14,000 < vehicle ≤ 26,000................................	$20,000
26,000 < vehicle...	$40,000

Table 2, below, shows the additional credits for passenger automobiles or light trucks.

Table 2.–Credit for Qualifying Fuel Cell Vehicles

	If Fuel Economy of the Fuel Cell Vehicle Is:	
Credit	**at least**	**but less than**
$1,000	150% of base fuel economy	175% of base fuel economy
$1,500	175% of base fuel economy	200% of base fuel economy
$2,000	200% of base fuel economy	225% of base fuel economy
$2,500	225% of base fuel economy	250% of base fuel economy
$3,000	250% of base fuel economy	275% of base fuel economy
$3,500	275% of base fuel economy	300% of base fuel economy
$4,000	300% of base fuel economy	

Hybrid vehicles

A qualifying hybrid vehicle is a motor vehicle that draws propulsion energy from on-board sources of stored energy which include both an internal combustion engine or heat engine using combustible fuel and a rechargeable energy storage system (e.g., batteries). The amount of credit for the purchase of a hybrid vehicle is the sum of two components. In the case of an automobile or light truck, the amount of credit is the sum of a base credit amount that varies with the amount of power available from the rechargeable storage system and a fuel economy credit amount that varies with the rated fuel economy of the vehicle compared to a 2002 model year standard. In addition, the vehicle must meet or exceed the EPA Tier II, bin 5 emissions standards. In the case of a heavy duty hybrid motor vehicle (a vehicle weighing more than 8,500 pounds),[5] the amount of credit is the sum of a base credit amount that varies, by vehicle weight class, with the amount of power available from the rechargeable storage system and an additional credit for early adoption of the technology that varies with the model year of the vehicle purchased.

For these purposes, a vehicle's power available from its rechargeable energy storage system as a percentage of maximum available power is calculated as the maximum value available from the battery or other energy storage device during a standard power test, divided by the sum of the battery or other energy storage device and the SAE net power of the heat engine.

Table 3, below, shows the base credit amounts for automobiles and light trucks.

Table 3.–Hybrid Vehicle Base Credit Amount for Automobiles and Light Trucks, Dependent Upon the Power Available from the Rechargeable Energy Storage System as a Percentage of the Vehicles Maximum Available Power

Base Credit Amount	If Rechargeable Energy Storage System Provides: at least	If Rechargeable Energy Storage System Provides: but less than
$250	4% of maximum available power	10% of maximum available power
$500	10% of maximum available power	20% of maximum available power
$750	20% of maximum available power	30% of maximum available power
$1,000	30% of maximum available power	

Table 4, below, shows the additional fuel economy credit available to a hybrid passenger automobile or light truck whose fuel economy (on a gasoline gallon equivalent basis) exceeds that of a base fuel economy. For these purposes the base fuel economy is the 2002 model year city fuel economy rating for vehicles of various weight classes (see below).

[5] Medium duty passenger vehicles as defined in 40 CFR 86.1830-01 are treated as a passenger automobile or light truck for the purpose of determining the allowable credit. However, medium duty passenger vehicles are only eligible for the base credit amount. There is not an additional fuel economy credit for medium duty passenger vehicles.

Table 4.–Additional Fuel Economy Credit for Hybrid Vehicles

Credit	If Fuel Economy of the Hybrid Vehicle Is:	
	at least	but less than
$500	125% of base fuel economy	150% of base fuel economy
$1,000	150% of base fuel economy	175% of base fuel economy
$1,500	175% of base fuel economy	200% of base fuel economy
$2,000	200% of base fuel economy	225% of base fuel economy
$2,500	225% of base fuel economy	250% of base fuel economy
$3,000	250% of base fuel economy	

Table 5 below, shows the base credit amounts for heavy duty hybrid vehicles weighing 14,000 pounds or less.

Table 5.–Hybrid Vehicle Base Credit Amount for Heavy Duty Vehicles Weighing Not More Than 14,000 pounds

Base Credit Amount	If Rechargeable Energy Storage System Provides:	
	at least	but less than
$1,000	20% of maximum available power	30% of maximum available power
$1,750	30% of maximum available power	40% of maximum available power
$2,000	40% of maximum available power	50% of maximum available power
$2,250	50% of maximum available power	60% of maximum available power
$2,500	60% of maximum available power	

In the case of heavy duty hybrid vehicles weighing not more than 14,000 pounds, the additional credit amount for early adoption of the 2007 emission standards technology is $3,000 for model year 2003 vehicles, $2,500 for model year 2004 vehicles, $2,000 for model year 2005 vehicles, and $1,500 for model year 2006 vehicles.

Table 6, below, shows the base credit amounts for heavy duty hybrid vehicles weighing more than 14,000 pounds but not more than 26,000 pounds.

Table 6.–Hybrid Vehicle Base Credit Amount for Heavy Duty Hybrid Vehicles Weighing More Than 14,000 Pounds, But Not More Than 26,000 Pounds

Base Credit Amount	If Rechargeable Energy Storage System Provides:	
	at least	but less than
$4,000	20% of maximum available power	30% of maximum available power
$4,500	30% of maximum available power	40% of maximum available power
$5,000	40% of maximum available power	50% of maximum available power
$5,500	50% of maximum available power	60% of maximum available power
$6,000	60% of maximum available power	

In the case of heavy duty hybrid vehicles weighing more than 14,000 pounds but not more than 26,000 pounds, the additional credit amount for early adoption of the 2007 emission standards technology is $7,750 for model year 2003 vehicles, $6,500 for model year 2004 vehicles, $5,250 for model year 2005 vehicles, and $4,000 for model year 2006 vehicles.

Table 7, below, shows the base credit amounts for heavy duty hybrid vehicles weighing more than 26,000 pounds.

Table 7.–Hybrid Vehicle Base Credit Amount for Heavy Duty Hybrid Vehicles Weighing More Than 26,000 Pounds

Base Credit Amount	If Rechargeable Energy Storage System Provides:	
	at least	but less than
$6,000	20% of maximum available power	30% of maximum available power
$7,000	30% of maximum available power	40% of maximum available power
$8,000	40% of maximum available power	50% of maximum available power
$9,000	50% of maximum available power	60% of maximum available power
$10,000	60% of maximum available power	

In the case of heavy duty hybrid vehicles weighing more than 26,000 pounds, the additional credit amount for early adoption of the 2007 emission standards technology is $12,000 for model year 2003 vehicles, $10,000 for model year 2004 vehicles, $8,000 for model year 2005 vehicles, and $6,000 for model year 2006 vehicles.

Alternative fuel vehicle

The credit for the purchase of a new alternative fuel vehicle is 40 percent of the incremental cost of such vehicle, plus an additional 30 percent if the vehicle meets certain emissions standards, but not more than between $5,000 and $40,000 depending upon the weight of the vehicle. Table 8, below, shows the maximum permitted incremental cost for the purpose of calculating the credit for alternative fuel vehicles by vehicle weight class.

Table 8.–Maximum Allowable Incremental Cost for Calculation of Alternative Fuel Vehicle Credit

Vehicle Gross Weight Rating in Pounds	Maximum Allowable Incremental Cost
vehicle ≤ 8,500..	$5,000
8,500 < vehicle ≤ 14,000.................................	$10,000
14,000 < vehicle ≤ 26,000...............................	$25,000
26,000 < vehicle..	$40,000

Alternative fuels comprise compressed natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, and any liquid fuel that is at least 85 percent methanol. Qualifying alternative fuel motor vehicles are vehicles that operate only on qualifying alternative fuels and are incapable of operating on gasoline or diesel (except in the extent gasoline or diesel fuel is part of a qualified mixed fuel, described below).

Certain mixed fuel vehicles, that is vehicles that use a combination of an alternative fuel and a petroleum-based fuel, are eligible for a reduced credit. If the vehicle operates on a mixed fuel that is at least 75 percent alternative fuel, the vehicle is eligible for 70 percent of the otherwise allowable alternative fuel vehicle credit. If the vehicle operates on a mixed fuel that is at least 90 percent alternative fuel, the vehicle is eligible for 90 percent of the otherwise allowable alternative fuel vehicle credit.

Base fuel economy

The base fuel economy is the Environmental Protection Agency's unadjusted 2002 model year city fuel economy for vehicles by inertia weight class by vehicle type. The "vehicle inertia weight class" is that defined in regulations prescribed by the Environmental Protection Agency for purposes of Title II of the Clean Air Act. Table 9, below, shows the 2002 model year city fuel economy for vehicles by type and by inertia weight class.

Table 9.–2002 Model Year City Fuel Economy

Vehicle Inertia Weight Class (pounds)	Passenger Automobile (miles per gallon)	Light Truck (miles per gallon)
1,500	45.2	39.4
1,750	45.2	39.4
2,000	39.6	35.2
2,250	35.2	31.8
2,500	31.7	29.0
2,750	28.8	26.8
3,000	26.4	24.9
3,500	22.6	21.8
4,000	19.8	19.4
4,500	17.6	17.6
5,000	15.9	16.1
5,500	14.4	14.8
6,000	13.2	13.7
6,500	12.2	12.8
7,000	11.3	12.1
8,500	11.3	12.1

Modification of credit for qualified electric vehicles

The bill repeals the phaseout of the credit for electric vehicles under present law. The provision also modifies present law to provide for a credit equal to the lesser of $1,500 or 10 percent of the manufacturer's suggested retail price of certain vehicles that conform to the Motor Vehicle Safety Standard 500. For all other electric vehicles, Table 10, below describes the credit.

Table 10.–Credit for Qualifying Battery Electric Vehicles

Vehicle Gross Weight Rating in Pounds	Credit Amount
Vehicle ≤ 8,500	$3,500
8,500 < vehicle ≤ 14,000..................................	$10,000
14,000 < vehicle ≤ 26,000................................	$20,000
26,000 < vehicle...	$40,000

If an electric vehicle weighing not more than 8,500 pounds has an estimated driving range of at least 100 miles on a single charge of the vehicle's batteries or if it is capable of a payload capacity of at least 1,000 pounds, then the credit amount in Table 10 is $6,000.

In the case of property purchased by tax-exempt persons, the seller may claim the credit. The provision allows taxpayers to carry forward unused credits for 20 years or carry unused credits back for three (but not to any taxable year before the date of enactment).

Extension of present-law section 179A

The bill extends the sunset date of the present law deduction for costs of qualified clean-fuel vehicle and clean-fuel vehicle refueling property through December 31, 2007 (December 31, 2011 in the case of property relating to hydrogen). The provision modifies the definition of refueling property in the case of property relating to hydrogen to include property for the production of hydrogen.

The phase-down of present law for clean-fuel vehicles is modified such that the taxpayer may claim 75 percent of the otherwise allowable deductible in 2004 and 2005 (2004 through 2009 in the case of property relating to hydrogen), 50 percent of the otherwise allowable deduction in 2006 (2010 in the case of property relating to hydrogen), and 25 percent of the otherwise allowable deduction in 2007 (2011 in the case of property relating to hydrogen).

Credit for installation of alternative fueling stations

The bill permits taxpayers to claim a 50-percent credit for the cost of installing clean-fuel vehicle refueling property[6] to be used in a trade or business of the taxpayer or installed at the principal residence of the taxpayer. In the case of retail clean-fuel vehicle refueling property the allowable credit may not exceed $30,000. In the case of residential clean-fuel vehicle refueling property the allowable credit may not exceed $1,000. The taxpayer's basis in the property is reduced by the amount of the credit and the taxpayer may not claim deductions under section 179A with respect to property for which the credit is claimed. In the case of refueling property installed on property owned or used by a tax-exempt person, the taxpayer that installs the

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[6] For the purpose of the credit for refueling property, refueling property is defined as in present-law section 179A as modified by this bill to include property for the production of hydrogen.

property may claim the credit. To be eligible for the credit, the property must be placed in service before January 1, 2008 (January 1, 2012 in the case of hydrogen). The credit allowable in the taxable year cannot exceed the difference between the taxpayer's regular tax (reduced by certain other credits) and the taxpayer's tentative minimum tax. The taxpayer may carry forward unused credits for 20 years.

Credit for retail sale of alternative fuels

The bill permits taxpayers to claim a credit equal to the gasoline gallon equivalent of 30 cents per gallon of alternative fuel sold in 2003, 40 cents per gallon in 2004, 50 cents per gallon in 2005, and 50 cents per gallon in 2006. Qualifying alternative fuels are compressed natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, and any liquid mixture consisting of at least 85 percent methanol or ethanol. The gasoline gallon equivalency of any alternative fuel is determined by reference to the British thermal unit content of the alternative fuel compared to a gallon of gasoline. The credit may be claimed for sales prior to January 1, 2007. Under the provision, the credit is part of the general business credit.

Effective Date

The provisions relating to the credit for new fuel cell motor vehicles, hybrid motor vehicles, and alternative fuel motor vehicles, the credit for battery electric vehicles, the credit for alternative fuel vehicle refueling property, and deductions for clean fuel vehicles and clean fuel refueling property are effective for property placed in service after the date of enactment, in taxable years ending after the date of enactment. The credit for retail sales of alternative fuels is effective for sales of fuels after the date of enactment, in taxable years ending after the date of enactment.

B. Modifications to Small Producer Ethanol Credit (sec. 205 of the bill and secs. 38, 40, 87, and 469 of the Code)

Present Law

Small producer credit

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

Taxation of cooperatives and their patrons

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

Reasons for Change

The Committee believes provisions allowing greater flexibility in utilizing the benefits of the small ethanol producer credit are consistent with the objective of the bill to increase availability of alternative fuels.

Explanation of Provision

The provision makes several modifications to the rules governing the small producer ethanol credit. First, the provision liberalizes the definition of an eligible small producer to include persons whose production capacity does not exceed 60 million gallons. Second, the provision allows cooperatives to elect to pass-through the small ethanol producer credits to its patrons. The credit allowed to a particular patron is that proportion of the credit that the cooperative elects to pass-through for that year as the amount of patronage of that patron for that year bears to total patronage of all patrons for that year.

Third, the provision repeals the rule that includes the small producer credit in income of taxpayers claiming it and liberalizes the ordering and carryforward/carryback rules for the small producer ethanol credit. Fourth, the provision allows the small producer credit to be claimed against the alternative minimum tax. Finally, the provision provides that the small producer ethanol credit is not treated as derived from a passive activity under the Code rules restricting credits and deductions attributable to such activities.

Effective Date

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

C. Increased Flexibility in Alcohol Fuels Income Tax Credit (sec. 206 of the bill and sec. 40 of the Code)

Present Law

An 18.4 cents-per-gallon excise tax is imposed on gasoline. The tax is imposed when the fuel is removed from a refinery unless the removal is to a bulk transportation facility (e.g., removal by pipeline or barge to a registered terminal). In the case gasoline removed in bulk by registered parties, tax is imposed when the gasoline is removed from the terminal facility, typically by truck (i.e., "breaks bulk"). If gasoline is sold to an unregistered party before it is removed from a terminal, tax is imposed on that sale. When the gasoline subsequently breaks bulk, a second tax is imposed. The payor of the second tax may file a refund claim if it can prove payment of the first tax. The party liable for payment of the gasoline excise tax is called a "position holder," defined as the owner of record inside the refinery or terminal facility.

A 52-cents-per-gallon income tax credit is allowed for ethanol used as a motor fuel (the "alcohol fuels credit"). The benefit of the alcohol fuels tax credit may be claimed as a reduction in excise tax payments when the ethanol is blended with gasoline ("gasohol"). The reduction is based on the amount of ethanol contained in the gasohol. The excise tax benefits apply to gasohol blends of 90 percent gasoline/10 percent ethanol, 92.3 percent gasoline/7.7 percent ethanol, or 94.3 percent gasoline/5.7 percent ethanol. The income tax credit is based on the amount of alcohol contained in the blended fuel.

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 Department regulations provide that gasohol blenders may claim the income tax credit and excise tax rate reductions for ethanol used in the production of ETBE. The regulations also provide a special election allowing refiners to claim the benefit of the excise tax rate reduction even though the fuel being removed from terminals does not contain the requisite percentages of ethanol for claiming the excise tax rate reduction.

Reasons for Change

The Committee believes the tax benefits currently available to ethanol used in the production of ETBE should be clarified statutorily. In addition, the Committee believes it appropriate to increase the flexibility by which the alcohol fuels credit may be claimed for alcohol used in the production of ETBE.

Explanation of Provision

The provision permits a taxpayer to transfer the alcohol fuels credit with respect to alcohol used in the production of ETBE to any registered position holder liable for excise taxes imposed under section 4081. Such position holder also must obtain from the transferor taxpayer a certificate that identifies the amount of alcohol used in the production of ETBE. The Secretary is to prescribe regulations as necessary to ensure that the credit is claimed once and not reassigned by the position holder.

Effective Date

The provision is effective date of enactment.

D. Income Tax Credit for Biodiesel Fuel Mixtures (sec. 207 of the bill and new sec. 40B of the Code)

Present Law

No income tax credit or excise tax rate reduction is provided for biodiesel fuels under present law. However, a 52-cents-per-gallon income tax credit (the "alcohol fuels credit") is allowed for ethanol and methanol (derived from renewable sources) when the alcohol is used as a highway motor fuel. The benefit of this income tax credit may be claimed through reductions in excise taxes paid on alcohol fuels. In the case of alcohol blended with other fuels (e.g., gasoline), the excise tax rate reductions are allowable only for blends of 90 percent gasoline/10 percent alcohol, 92.3 percent gasoline/7.7 percent alcohol, or 94.3 percent gasoline/5.7 percent alcohol. These present law provisions are scheduled to expire in 2007.

Reasons for Change

The Committee believes that providing a new income tax credit for biodiesel fuel will promote energy self-sufficiency and also is consistent with the environmental objectives of the bill.

Explanation of Provision

The provision provides a new income tax credit for qualified biodiesel mixtures. A qualified biodiesel mixture is a mixture of diesel fuel and biodiesel that (1) is sold by the taxpayer producing such mixture to any person for use as a fuel, or (2) is used as a fuel by the taxpayer producing such mixture. Biodiesel is monoalkyl esters of long chain fatty acids for use in diesel-powered engines and which meet the registration requirements of the Environmental Protection Agency under section 211 of the Clean Air Act (42 U.S.C. sec. 7545) and the American Society of Testing and Materials D6751. Agri-biodiesel means biodiesel derived solely from virgin oils, including esters derived from corn, soybeans, sunflower seeds, cottonseeds, canola, crambe, rapeseeds, safflowers, flaxseeds, rice bran, mustard seeds, or animal fats. Recycled biodiesel is biodiesel derived from nonvirgin vegetable oils or nonvirgin animal fats. Virgin vegetable oils or animal fats mixed with recycled biodiesel will be treated as recycled biodiesel.

The biodiesel mixture credit is the sum of the products of the biodiesel mixture rate for each qualified biodiesel mixture and the number of gallons of such mixture of the taxpayer for the taxable year. The per gallon biodiesel mixture rate for agri-biodiesel equals one cent for each percentage point of biodiesel in the qualified biodiesel mixture, subject to a maximum credit of 20 cents per blended gallon of fuel. Agri-biodiesel used in the production of a qualified biodiesel mixture is taken into account only if a certification from the producer of the agri-biodiesel which identifies the product produced is obtained. The per gallon biodiesel mixture rate for recycled biodiesel equals 0.5 cent for each percentage point of biodiesel in the qualified biodiesel mixture, subject to a maximum credit of 10 cents per blended gallon of fuel.

The amount of the biodiesel mixture credit is includible in income. The credit may not be carried back to a taxable year beginning before date of enactment.

Effective Date

The biodiesel mixture credit is effective for biodiesel fuel sold after date of enactment, and before January 1, 2006.

E. Alcohol Fuel and Biodiesel Mixtures Excise Tax Credit (sec. 208 of the bill, secs. 40, 4081, 6427, 9503, and new sec. 6426 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.[7]

A taxpayer (generally a petroleum refiner, distributor, or marketer) who mixes ethanol with gasoline (or a special fuel[8]) 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.[9]

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

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[7] 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.

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

[9] 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 lease 150 but less than 190, the low-proof blender amount is 38.52 cents for sales or uses during calendar year 2003 and 2004, and 37.78 cents for calendar years 2005, 2006, and 2007.

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

Excise tax reductions for alcohol mixture fuels

Generally, motor fuels tax rates are as follows[10]:

Gasoline	18.4 cents per gallon
Diesel fuel and kerosene	24.4 cents per gallon
Special motor fuels	18.4 cents per gallon generally

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

Gasohol

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

The reduced excise tax rates apply to gasohol upon its removal or entry. Gasohol is defined as a gasoline/ethanol blend that contains 5.7 percent ethanol, 7.7 percent ethanol, or 10 percent ethanol. The Federal excise tax on gasoline is 18.4 cents per gallon. For the calendar year 2003, the following reduced rates apply to gasohol:[11]

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

Reduced excise tax rates also apply when gasoline is being purchased for the production of "gasohol." When gasoline is purchased for blending into gasohol, the rates above are multiplied by a fraction (e.g., 10/9 for 10-percent gasohol) so that the increased volume of motor

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[10] These rates include 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.

[11] 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 on September 30, 2007 (sec. 4081(c)(8)).

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.[12]

Qualified methanol and ethanol fuels

Alcohol produced from a substance other than petroleum or natural gas

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.[13] The rate of tax on qualified methanol is 12.35 cents per gallon. The rate on qualified ethanol in 2003 and 2004 is 13.15 cents. From January 1, 2005 through September 30, 2007, the rate of tax on qualified ethanol is 13.25 cents.[14]

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.[15] 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 31, 2005, the rate is reduced to 2.15 per gallon when the mixture does not contain ethanol and 4.3 cents per gallon in all other cases.

Blends of alcohol and diesel fuel or special motor fuels

A reduced rate of tax applies to diesel fuel or kerosene that is combined with alcohol as long as at least 10 percent of the finished mixture is alcohol. If none of the alcohol in the mixture is ethanol, the rate of tax is 18.4 cents per gallon. For alcohol mixtures containing ethanol, the rate of tax in 2003 and 2004 is 19.2 cents per gallon and for 2005 through September 30, 2007, the rate for ethanol mixtures is 19.3 cents per gallon. Fuel removed or entered for use in producing a 10 percent diesel-alcohol fuel mixture (without ethanol), is subject to a tax of 20.44 cents. The rate of tax for fuel removed or entered to produce a 10 percent diesel-ethanol fuel mixture is 21.333 cents per gallon for 2003 and 2004 and 21.444 cents per gallon for the period January 1, 2005 through September 30, 2007.

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[12] 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.

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

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

[15] 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)).

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.[16] Fuel mixtures containing at least 10 percent alcohol are taxed at lower rates.[17] In the case of 10 percent ethanol mixtures, any sale or use during 2003 and 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.[18]

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 Department regulations provide that gasohol blenders may claim the income tax credit and excise tax rate reductions for ethanol used in the production of ETBE. The regulations also provide a special election allowing refiners to claim the benefit of the excise tax rate reduction even though the fuel being removed from terminals does not contain the requisite percentages of ethanol for claiming the excise tax rate reduction.

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

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

[18] Sec. 4091(c)(1). In the case of aviation fuel for use in producing an aviation alcohol fuel mixture, the rate of tax is 10/9 of the rate that would have been applicable to such mixture had such mixture been created prior to sale.

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.[19] 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.[20]

Biodiesel

If biodiesel is used in the production of blended taxable fuel, the Code imposes tax on the removal or sale of the blended taxable fuel.[21] In addition, the Code imposes tax on any liquid other than gasoline sold for use or used as a fuel in a diesel-powered highway vehicle or diesel-powered train unless tax was previously imposed and not refunded or credited.[22] If biodiesel that was not previously taxed or exempt is sold for use or used as a fuel in a diesel-powered highway vehicle or a diesel-powered train, tax is imposed.[23] There are no reduced excise tax rates for biodiesel.

Reasons for Change

The United States seeks to reduce its dependence on foreign oil through, among other means, the use of alternative fuels. The Committee believes that the goal of promoting the use of alternative fuels can be achieved without decreasing the revenues available for improving the nation's highway and bridge network. As a result, the Committee believes that it is appropriate that the entire amount of alcohol fuel taxes be devoted to the Highway Trust Fund. 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.

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

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

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

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

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

Explanation of Provision

Overview

The provision eliminates reduced rates of excise tax for most alcohol-blended fuels. In place of reduced rates, the provision creates two new credits: the alcohol fuel mixture credit and the biodiesel mixture credit. The sum of these credits may be taken against the tax imposed on taxable fuels (by section 4081). Alternatively, in lieu of a credit against tax, the provision allows taxpayers to file a claim for payment equal to the amount of these credits. The provision also eliminates the General Fund retention of certain taxes on alcohol fuels, and credits these taxes to the Highway Trust Fund and extends the present-law alcohol fuels credit through December 31, 2010.

Alcohol fuel mixture excise tax credit

The provision eliminates the reduced rates of excise tax for most alcohol-blended fuels.[24] Under the provision, the full rate of tax for taxable fuels is imposed on both alcohol fuel mixtures and the taxable fuel used to produce an alcohol fuel mixture.

In lieu of the reduced excise tax rates, the provision provides for an excise tax credit, the alcohol fuel mixture credit. The alcohol fuel mixture credit is 52 cents for each gallon of alcohol used by a person in producing an alcohol fuel mixture. 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. Equivalent amounts of these credits are to be credited to the Highway Trust Fund.

For purposes of the alcohol fuel mixture credit, an "alcohol fuel mixture" is (1) a mixture of alcohol and a taxable fuel and (2) 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). Taxable fuel is gasoline, diesel and kerosene.[25]

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

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

[25] Sec. 4083(a)(1).

Biodiesel mixture excise tax credit

The provision provides an excise tax credit for agri-biodiesel mixtures. The credit is one dollar for the first gallon of agri-biodiesel used by the taxpayer in producing at least five gallons of qualified biodiesel mixture.[26] The credit is not available for any sale or use for any period after December 31, 2005. This excise tax credit is coordinated with income tax credit for biodiesel such that credit for the same biodiesel cannot be claimed for both income and excise tax purposes.

Payments with respect to tax-paid fuel used to produce qualified mixtures

When tax-paid fuel is used to produce an alcohol fuel mixture or qualified biodiesel mixture that is sold or used in the trade or business of the person who makes such a mixture, a payment in an amount equal to the alcohol fuel mixture credit or biodiesel mixture credit is available. This refund provision is available to persons using gasoline, diesel fuel or kerosene to make an alcohol fuel mixture or qualified biodiesel mixture. Specifically, if any gasoline, diesel fuel, or kerosene on which tax was imposed by section 4081 is used by any person in producing an alcohol fuel mixture or qualified biodiesel mixture which is sold or used in such person's trade or business, the Secretary is to pay to such person an amount equal to the alcohol fuel mixture credit or the biodiesel mixture credit with respect to such gasoline, diesel fuel or kerosene.

If such claims 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. The refund provision is coordinated with other refund provisions and the excise tax credits for alcohol fuel mixtures and biodiesel mixtures. The provision does not apply with respect to alcohol fuel mixtures sold or used after December 31, 2010 or qualified biodiesel mixtures sold or used after December 31, 2005.

Highway Trust Fund

The provision eliminates the requirement that 2.5 and 2.8 cents per gallon of excise taxes be retained in the General Fund so 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 biodiesel mixtures.

Alcohol fuels income tax credit

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

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[26] Agri-biodiesel is monoalkyl esters of long chain fatty acids for use in diesel-powered engines that is derived from virgin oils, including that from corn, soybeans, sunflower seeds, cottonseeds, canola, crambe, rapeseeds, safflowers, flaxseeds, rice bran, mustard seeds, or animal fats. The excise tax credit employs the same definitions as the biodiesel income tax credit created by section 207 of the bill.

Effective Date

The provision is effective for fuel sold or used after September 30, 2003.

F. Sale of Gasoline and Diesel Fuel at Duty-Free Sales Enterprises (sec. 209 of the bill)

Present Law

A duty-free sales enterprise that meets certain conditions may sell and deliver for export from the customs territory of the United States duty-free merchandise. Duty-free merchandise is merchandise sold by a duty-free sales enterprise on which neither federal duty nor federal tax has been assessed pending exportation from the customs territory of the United States. Conditions for qualifying as a duty-free enterprise include (but are limited to) locations within a specified distance from a port of entry, establishment of procedures for ensuring that merchandize is exported from the United States, and prominent posting of rules concerning duty-free treatment of merchandise. The duty-free statute does not contain any limitation on what goods may qualify for duty-free treatment.

Reasons for Change

The Committee understands that in some circumstances individuals purchase motor fuels at a duty free facility that is located in the United States, drive briefly outside of the United States, and return to the United States. The Committee believes that motor fuel sold at duty-free enterprises should support the financing of the U.S. highway system as do other motor fuel sales in the United States.

Explanation of Provision

The provision amends Section 555(b) of the Tariff Act of 1930 (19 U.S.C. 1555(b)) to provide that gasoline or diesel fuel sold at duty-free enterprises shall be considered to entered for consumption into the United States and thus ineligible for classification as duty-free merchandise.

Effective Date

The provision is effective on the date of enactment.

TITLE III – CONSERVATION AND ENERGY EFFICIENCY PROVISIONS

A. Credit for Construction of New Energy-Efficient Home (sec. 301 of the bill and new sec. 45G of the Code)

Present Law

A nonrefundable, 10-percent business energy credit is allowed for the cost of new property that is equipment (1) that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage.

The business energy tax credits are components of the general business credit (sec. 38(b)(1)). The business energy tax credits, 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).

A taxpayer may exclude from income the value of any subsidy provided by a public utility for the purchase or installation of an energy conservation measure. An energy conservation measure means any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit (sec. 136).

There is no present-law credit for the construction of new energy-efficient homes.

Reasons for change

The Committee recognizes that residential energy use for heating and cooling represents a large share of national energy consumption, and accordingly believes that measures to reduce heating and cooling energy requirements have the potential to substantially reduce national energy consumption. The Committee further recognizes that the most cost-effective time to properly insulate a home is when it is under construction and that the most effective mechanism to encourage the utilization of energy-efficient components in the construction of new homes is through an incentive to the builder. Accordingly, the Committee believes that a tax credit for the use of energy-efficiency components in a home's envelope (exterior windows (including skylights) and doors and insulation) or heating and cooling appliances will encourage contractors to produce highly energy-efficient homes, which in turn will reduce national energy consumption. Reduced energy consumption will in turn reduce reliance on foreign suppliers of oil and will reduce pollution in general.

Explanation of Provision

The provision provides a credit to an eligible contractor of an amount equal to the aggregate adjusted bases of all energy-efficient property installed in a qualified new energy-efficient home during construction. The credit cannot exceed $1,000 ($2,000) in the case of a new home that has a projected level of annual heating and cooling costs that is 30 percent (50 percent) less than a comparable dwelling constructed in accordance with Chapter 4 of the 2000 International Energy Conservation Code.

The eligible contractor is the person who constructed the home, or in the case of a manufactured home, the producer of such home. Energy efficiency property is any energy-efficient building envelope component (insulation materials or system designed to reduce heat loss or gain, and exterior windows, including skylights, and doors) and any energy-efficient heating or cooling appliance that can, individually or in combination with other components, meet the standards for the home.

To qualify as an energy-efficient new home, the home must be: (1) a dwelling located in the United States; (2) the principal residence of the person who acquires the dwelling from the eligible contractor, and (3) certified to have a projected level of annual heating and cooling energy consumption that meets the standards for either the 30-percent or 50-percent reduction in energy usage. The home may be certified according to a component-based method or an energy performance based method. Additionally, manufactured homes certified by the Environmental Protection Agency's Energy Star Labeled Homes program are eligible for the $1,000 credit provided criteria (1) and (2) are met.

The component-based method of certification shall be based on applicable energy-efficiency specifications or ratings, including current product labeling requirements. The Secretary shall develop component-based packages that are equivalent in energy performance to properties that qualify for the credit. The standard for certifying homes through the component based method shall be based on the same standards for plan check and physical inspections as are used for energy code compliance. The certification shall be provided by a local building regulatory authority, a utility, a manufactured home primary inspection agency, or a home energy rating organization. Such provider of the certification must be financially independent of the eligible contractor.

The performance-based method of certification shall be based on an evaluation of the home in reference to a home which uses the same energy source and system heating type, and is constructed in accordance with the Chapter 4 of the 2000 International Energy Conservation Code. The certification shall be provided by an individual recognized by the Secretary for such purposes.

The certification process requires that energy savings to the consumer be measured in terms of energy costs. To ensure consistent and reasonable energy cost analyses, the Department of Energy shall include in its rulemaking related to this bill specific reference data to be used for qualification for the credit.

In the case of manufactured homes, certification shall be by the Energy Star Labeled Homes program.

The credit will be part of the general business credit. No credits attributable to energy efficient homes may be carried back to any taxable year ending on or before the effective date of the credit.

Effective Date

The credit applies to homes whose construction is substantially completed after the date of enactment and which are purchased during the period beginning on the date of enactment and ending on December 31, 2007 (December 31, 2005 in the case of the $1,000 credit).

B. Credit for Energy-Efficient Appliances (sec. 302 of the bill and new sec. 45H of the Code)

Present Law

A nonrefundable, 10-percent business energy credit is allowed for the cost of new property that is equipment: (1) that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat; or (2) used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage.

The business energy tax credits are components of the general business credit (sec. 38(b)(1)). The business energy tax credits, 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).

A taxpayer may exclude from income the value of any subsidy provided by a public utility for the purchase or installation of an energy conservation measure. An energy conservation measure means any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit (sec. 136).

There is no present-law credit for the manufacture of energy-efficient appliances.

Reasons for change

The Committee believes that providing a tax credit for the production of energy-efficient clothes washers and refrigerators will encourage manufacturers to produce such products currently and to invest in technologies to achieve higher energy-efficiency standards for the future. In addition, the Committee intends to encourage those manufacturers already producing energy-efficient clothes washers and refrigerators to accelerate production.

Explanation of Provision

The provision provides a credit for the production of certain energy-efficient clothes washers and refrigerators. The credit would equal $50 per appliance for energy-efficient clothes washers produced with a modified energy factor ("MEF") of 1.42 MEF or greater for washers produced before 2007 and for refrigerators produced before 2005 that consume 10 percent less kilowatt-hours per year than the energy conservation standards promulgated by the Department of Energy that took effect on July 1, 2001. The credit equals $100 for energy-efficient clothes washers produced with a MEF of 1.5 or greater and for refrigerators produced that consume at least 15 percent less kilowatt-hours per year (at least 20 percent less for production in 2007) than the energy conservation standards promulgated by the Department of Energy that took effect on July 1, 2001. The credit is $150 in the case of a refrigerator that consumes at least 20 percent less kilowatt-hours per year than such standards and is produced before 2007. A refrigerator must be an automatic defrost refrigerator-freezer with an internal volume of at least 16.5 cubic feet to qualify for the credit. A clothes washer is any residential clothes washer, including a residential style coin operated washer, that satisfies the relevant efficiency standard.

For each category of appliances (e.g., washers that meet the lower MEF standard, washers that meet the higher MEF standard, refrigerators that meet the 10 percent standard, refrigerators that meet the 15 percent standard), only production in excess of average production for each such category during calendar years 2000-2002 would be eligible for the credit. For 2003, only production after the date of enactment is eligible for the credit, and special rules apply to determine if production exceeds the average of the base period. The taxpayer may not claim credits in excess of $60 million for all taxable years, and may not claim credits in excess of $30 million with respect to appliances that only qualify for the $50 credit. Additionally, the credit allowed for all appliances may not exceed two percent of the average annual gross receipts of the taxpayer for the three taxable years preceding the taxable year in which the credit is determined.

The credit will be part of the general business credit. No credits attributable to energy-efficient appliances may be carried back to taxable years ending before January 1, 2003.

Effective Date

The credit applies to appliances produced after the date of enactment and prior to January 1, 2008.

C. Credit for Residential Energy Efficient Property (sec. 303 of the bill and new sec. 25C of the Code)

Present Law

A taxpayer may exclude from income the value of any subsidy provided by a public utility for the purchase or installation of an energy conservation measure. An energy conservation measure means any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit (sec. 136).

There is no present-law personal tax credit for energy efficient residential property.

Reasons for change

The Committee believes that allowing a credit for the purchase of certain energy efficient appliances and systems that generate electricity through renewable and pollution-free alternative energy sources will encourage the purchase of these products. The Committee believes that the use of these products will help reduce reliance on conventional energy sources and reduce atmospheric pollutants. The Committee believes that the on-site generation of electricity and solar hot water will reduce reliance on the United States' electricity grid and on natural gas pipelines. Furthermore, the Committee believes that the use of highly efficient residential equipment will lead to decreased energy consumption in households, resulting in significant energy savings.

Explanation of Provision

The provision provides a personal tax credit for the purchase of qualified wind energy property, qualified photovoltaic property, and qualified solar water heating property that is used exclusively for purposes other than heating swimming pools and hot tubs. The credit is equal to 15 percent for solar water heating property and photovoltaic property, and 30 percent for wind energy property. The maximum credit for each of these systems of property is $2,000. The provision also provides a 30 percent credit for the purchase of qualified fuel cell power plants. The credit for any fuel cell may not exceed $500 for each 0.5 kilowatt of capacity.

Qualifying solar water heating property means an expenditure for property to heat water for use in a dwelling unit located in the United States and used as a residence if at least half of the energy used by such property for such purpose is derived from the sun. Qualified photovoltaic property is property that uses solar energy to generate electricity for use in a dwelling unit. Solar panels are treated as qualified photovoltaic property. Qualified wind energy property is property that uses wind energy to generate electricity for use in a dwelling unit. A qualified fuel cell power plant is an integrated system comprised of a fuel cell stack assembly and associated balance of plant components that converts a fuel into electricity using electrochemical means, and which has an electricity-only generation efficiency of greater than 30 percent and that generates at least 0.5 kilowatts of electricity. The qualified fuel cell power plant must be installed on or in connection with a dwelling unit located in the United States and used by the taxpayer as a principal residence.

The provision also provides a credit for the purchase of other qualified energy efficient property, as described below:

Electric heat pump hot water heaters with an Energy Factor of at least 1.7. The maximum credit is $75 per unit.

Electric heat pumps with a heating efficiency of at least 9 HSPF (Heating Seasonal Performance Factor) and a cooling efficiency of at least 15 SEER (Seasonal Energy Efficiency Rating) and an energy efficiency ratio (EER) of 12.5 or greater. The maximum credit is $250 per unit.

Natural gas, oil, or propane furnace which achieves 95 percent annual fuel utilization efficiency. The maximum credit is $250 per unit.

Central air conditioners with an efficiency of at least 15 SEER and an EER of 12.5 or greater. The maximum credit is $250 per unit.

Natural gas, oil, or propane water heaters with an Energy Factor of at least 0.8. The maximum credit is $75 per unit.

Geothermal heat pumps which have an EER of at least 21. The maximum credit is $250 per unit.

The credit is nonrefundable, and the depreciable basis of the property is reduced by the amount of the credit. Expenditures for labor costs allocable to onsite preparation, assembly, or original installation of property eligible for the credit are eligible expenditures. The credit is allowed against the regular and alternative minimum tax.

Certain equipment safety requirements need to be met to qualify for the credit. Special proration rules apply in the case of jointly owned property, condominiums, and tenant-stockholders in cooperative housing corporations. With the exception of wind energy property, if less than 80 percent of the property is used for nonbusiness purposes, only that portion of expenditures that is used for nonbusiness purposes is taken into account.

Effective Date

The credit applies to purchases after the date of enactment and before January 1, 2008.

D. Credit for Business Installation of Qualified Fuel Cells and Stationary Microturbine Power Plants (sec. 304 of the bill and sec. 48 of the Code)

Present Law

A nonrefundable, 10-percent business energy credit is allowed for the cost of new property that is equipment (1) that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage.

The business energy tax credits are components of the general business credit (sec. 38(b)(1)). The business energy tax credits, 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. An unused general business credit generally may be carried back one year and carried forward 20 years (sec. 39).

A taxpayer may exclude from income the value of any subsidy provided by a public utility for the purchase or installation of an energy conservation measure. An energy conservation measure means any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit (sec. 136).

There is no present-law credit for fuel cell power plant or microturbine property.

Reasons for change

The Committee believes that investments in qualified fuel cell power plants represent a promising means to produce electricity through non-polluting means and from nonconventional energy sources. Furthermore, the on-site generation of electricity provided by fuel cell power plants, as well as that by microturbines, will reduce reliance on the United States' electricity grid. The Committee believes that providing a tax credit for investment in qualified fuel cell and microturbine power plants will encourage investments in such systems.

Explanation of Provision

The provision provides a 30 percent business energy credit for the purchase of qualified fuel cell power plants for businesses. A qualified fuel cell power plant is an integrated system comprised of a fuel cell stack assembly and associated balance of plant components that converts a fuel into electricity using electrochemical means, and which has an electricity-only generation efficiency of greater than 30 percent and generates at least 0.5 kilowatts of electricity using an electrochemical process. The credit for any fuel cell may not exceed $500 for each 0.5 kilowatts of capacity.

Additionally, the provision provides a 10 percent credit for the purchase of qualifying stationary microturbine power plants. A qualified stationary microturbine power plant is an integrated system comprised of a gas turbine engine, a combustor, a recuperator or regenerator, a generator or alternator, and associated balance of plant components which converts a fuel into electricity and thermal energy. Such system also includes all secondary components located between the existing infrastructure for fuel delivery and the existing infrastructure for power distribution, including equipment and controls for meeting relevant power standards, such as voltage, frequency and power factors. Such system must have an electricity-only generation efficiency of not less that 26 percent at International Standard Organization conditions and a capacity of less than 2,000 kilowatts. The credit is limited to the lesser of 10 percent of the basis of the property or $200 for each kilowatt of capacity.

The credit is nonrefundable. The taxpayer's basis in the property is reduced by the amount of the credit claimed.

Effective Date

The credit for businesses applies to property placed in service after the date of enactment and before January 1, 2008 (January 1, 2007 in the case of microturbines), under rules similar to rules of section 48(m) of the Internal Revenue Code of 1986 (as in effect on the day before the date of enactment of the Revenue Reconciliation Act of 1990).

E. Energy-Efficient Commercial Buildings Deduction (sec. 305 of the bill and new sec. 179B of the Code)

Present Law

No special deduction is currently provided for expenses incurred for energy-efficient commercial building property.

Reasons for change

The Committee recognizes that commercial buildings consume a significant amount of energy resources and that reductions in commercial energy use have the potential to significantly reduce national energy consumption. Accordingly, the Committee believes that a special deduction for commercial building property (lighting, heating, cooling, ventilation, and hot water supply systems) that meets a high energy-efficiency standard will encourage construction of buildings that are significantly more energy efficient than the norm. The Committee further believes that the special deduction will encourage innovation to reduce the costs of meeting the energy-efficiency standard.

Explanation of Provision

The provision provides a deduction equal to energy-efficient commercial building property expenditures made by the taxpayer. Energy-efficient commercial building property expenditures are defined as amounts paid or incurred for energy-efficient property installed in connection with the new construction or reconstruction of property: (1) which is depreciable property; (2) which is located in the United States, and (3) which is the type of structure to which the Standard 90.1-2001 of the American Society of Heating, Refrigerating, and Air Conditioning Engineers and the Illuminating Engineering Society of North America ("ASHRAE/IESNA") is applicable. The deduction is limited to an amount equal to $2.25 per square foot of the property for which such expenditures are made. The deduction is allowed in the year in which the property is placed in service.

Energy-efficient commercial building property generally means any property that reduces total annual energy and power costs with respect to the lighting, heating, cooling, ventilation, and hot water supply systems of the building by 50 percent or more in comparison to a building which minimally meets the requirements of Standard 90.1-2001 of ASHRAE/IESNA. Because of the requirement that in order to qualify, a building must fall within the scope of the ASHRAE/IESNA Standard 90.1-2001, residential rental property that is less than four stories does not qualify.

Certain certification requirements must be met in order to qualify for the deduction. The Secretary, in consultation with the Secretary of Energy, will promulgate regulations that describe methods of calculating and verifying energy and power costs. The methods for calculation shall be fuel neutral, such that the same energy efficiency features shall qualify a building for the deduction under this subsection regardless of whether the heating source is a gas or oil furnace or an electric heat pump. To allow proper calculations of cost, the Secretary shall prescribe the costs per unit of energy and power, such as kilowatt hour, kilowatt, gallon of fuel oil, and cubic foot or Btu of natural gas, which may be dependent on time of usage. If a State has developed annual energy usage and cost reduction procedures based on time of usage costs for use in the performance standards of the State's building energy code before the effective date of this section, the Secretary may allow taxpayers in that State to use those annual energy usage and cost reduction procedures in lieu of those adopted by the Secretary.

The Secretary shall promulgate procedures for the inspection and testing for compliance of buildings that are comparable, given the difference between commercial and residential buildings, to the requirements in the Mortgage Industry National Home Energy Rating Standards. Individuals qualified to determine compliance shall only be those recognized by one or more organizations certified by the Secretary for such purposes. In order that the deduction is available immediately, it is expected that the Secretary will promptly issue interim guidance with respect to the methods of calculating and verifying energy and power costs that relies on provisions of ASHRAE/IESNA Standard 90.1-2001 and of the 2001 California Nonresidential Alternative Calculation Method Approval Manual or the 2001 California Residential Alternative Calculation Method Approval Manual. The methods for calculation need not comply fully with section 11 of ASHRAE/IESNA Standard 90.1-2001. Such interim guidance will include interim guidance as to the qualified computer software and qualified individuals necessary to certify eligibility for the deduction.

When final regulations are adopted, such regulations additionally may, with respect to methods of calculating and verifying energy and power costs, take into consideration appropriate energy savings from design methodologies and technologies not otherwise credited in ASHRAE/IESNA Standard 90.1-2001, the 2001 California Nonresidential Alternative Calculation Method Approval Manual, or the 2001 California Residential Alternative Calculation Method Approval Manual, including the following: (1) natural ventilation, (2) evaporative cooling, (3) automatic lighting controls such as occupancy sensors, photocells, and timeclocks, (4) daylighting, (5) designs utilizing semi-conditioned spaces which maintain adequate comfort conditions without air conditioning or without heating, (6) improved fan system efficiency, including reductions in static pressure, and (7) advanced unloading mechanisms for mechanical cooling, such as multiple or variable speed compressors. Additionally, the calculation methods may take into account the extent of commissioning in the building, and allow the taxpayer to take into account measured performance which exceeds typical performance.

For energy-efficient commercial building property public property expenditures made by a public entity, such as public schools, the interim guidance, as well as final regulations, will allow the value of the deduction (determined without regard to the tax-exempt status of such entity) to be allocated to the person primarily responsible for designing the property in lieu of the public entity.

Effective Date

The provision is effective for taxable years beginning after the date of enactment for expenditures in connection with a building whose construction is completed on or before December 31, 2009.

F. Three-Year Applicable Recovery Period for Depreciation of Qualified Energy Management Devices (sec. 306 of the bill and sec. 168 of the Code)

Present Law

No special recovery period is currently provided for depreciation of qualified energy management devices.

Reasons for Change

The Committee believes that consumers could better manage their electricity use if they had better information concerning their usage habits by time of day. In the case of electricity, if time-of-day pricing is used, energy management devices that provide information to consumers regarding their peak electrical use could encourage consumers to defer certain electrical use, such as use of a washing machine, to periods of the day when electricity prices are lower. In addition to potentially reducing consumers' electricity bill, spreading the demand for electricity more evenly throughout the day will reduce the need for utility investments in generation capacity to satisfy peak demand periods.

The Committee believes that providing a 3-year recovery period for qualified energy management devices will provide sufficient incentive for utilities to establish time-of-day pricing options that will encourage consumers to adjust their electricity usage in such a manner to dampen utilities' peak load capacity needs and thus reduce the need for investment in new capacity to meet peak load demand.

Explanation of Provision

The provision provides a three-year recovery period for qualified new energy management devices placed in service by any taxpayer who is a supplier of electric energy or is a provider of electric energy services. A qualified energy management device is any meter or metering device eligible for accelerated depreciation under code section 168 and which is used by the taxpayer

(1) to measure and record electricity usage data on a time-differentiated basis in at least 4 separate time segments per day, and

(2) to provide such data on at least a monthly basis to both consumers and the taxpayer.

Effective Date

The provision is effective for any qualified energy management device placed in service after the date of enactment of the Act and before January 1, 2008.

G. Three-Year Applicable Recovery Period for Depreciation of Qualified Water Submetering Devices (sec. 307 of the bill and sec. 168 of the Code)

Present Law

No special recovery period is currently provided for depreciation of qualified water submetering devices.

Reasons for Change

The Committee believes that consumers would better manage their water use if they paid for water in proportion to the water that they actually used. In many cases in multi-unit properties, there is not unit by unit metering of water use. Rather, the landlord's average per-unit costs for water are reflected in rental rates. Thus, individual units have virtually no financial incentive to conserve on water use, as the cost of any individual's increased water usage is borne by all dwellers. The Committee believes that a tax incentive for the installation of submeters to enable unit-by unit charges that reflect water usage will rationalize water use and help to conserve water resources.

Explanation of Provision

The provision provides a three-year recovery period for qualified new water submetering devices placed in service by any taxpayer who is an eligible resupplier. An eligible resupplier is any taxpayer who purchases and installs qualified water submetering devices in every unit in any multi-unit property. A qualified water submetering device is anywater submetering device eligible for accelerated depreciation under code section 168 and which is used by the taxpayer

(1) to measure and record water usage data, and

(2) to provide such data on at least a monthly basis to both consumers and the taxpayer.

Effective Date

The provision is effective for any qualified water submetering device placed in service after the date of enactment of the Act and before January 1, 2008.

H. Energy Credit for Combined Heat and Power System Property (sec. 308 of the bill and sec. 48 of the Code)

Present Law

A nonrefundable, 10-percent business energy credit is allowed for the cost of new property that is equipment (1) that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage.

The business energy tax credits are components of the general business credit (sec. 38(b)(1)). The business energy tax credits, 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).

A taxpayer may exclude from income the value of any subsidy provided by a public utility for the purchase or installation of an energy conservation measure. An energy conservation measure means any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit (sec. 136).

There is no present-law credit for combined heat and power ("CHP") property.

Reasons for change

The Committee believes that investments in combined heat and power systems represent a promising means to achieve greater national energy efficiency by encouraging the dual use of the energy from the burning of fossil fuels. Furthermore, the on-site generation of electricity provided by CHP systems will reduce reliance on the United States' electricity grid. The Committee believes that providing a tax credit for investment in combined heat and power property will encourage investments in such systems

Explanation of Provision

The provision provides a 10-percent credit for the purchase of combined heat and power property. CHP property as defined as property: (1) which uses the same energy source for the simultaneous or sequential generation of electrical power, mechanical shaft power, or both, in combination with the generation of steam or other forms of useful thermal energy (including heating and cooling applications); (2) which has an electrical capacity of more than 50 kilowatts or a mechanical energy capacity of more than 67 horsepower or an equivalent combination of electrical and mechanical energy capacities; (3) which produces at least 20 percent of its total useful energy in the form of thermal energy and at least 20 percent in the form of electrical or mechanical power (or a combination thereof); and (4) the energy efficiency percentage of which exceeds 60 percent (70 percent in the case of a system with an electrical capacity in excess of 50 megawatts or a mechanical energy capacity in excess of 67,000 horsepower, or an equivalent combination of electrical and mechanical capacities.) Also, for purposes of determining whether CHP property includes technologies which generate electricity or mechanical power using back-pressure steam turbines in place of existing pressure-reducing valves, or which make use of waste heat from industrial processes such as by using organic rankine, stirling, or kalina heat engine systems, the general requirements of clause (1), the energy output requirements related to heat versus power described under (3), and the energy efficiency requirements of (4), above, may be disregarded.

CHP property does include property used to transport the energy source to the generating facility or to distribute energy produced by the facility.

If a taxpayer is allowed a credit for CHP property, and the property would ordinarily have a depreciation class life of 15 years or less, the depreciation period for the property is treated as having a 22-year class life. The present-law carry back rules of the general business credit generally would apply except that no credits attributable to combined heat and power property may be carried back before the effective date of this provision.

Effective Date

The credit applies to property placed in service after the date of enactment and before January 1, 2007.

I. Credit for Energy Efficiency Improvements to Existing Homes (sec. 309 of the bill and new sec. 25D of the Code)

Present Law

A taxpayer may exclude from income the value of any subsidy provided by a public utility for the purchase or installation of an energy conservation measure. An energy conservation measure means any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit (sec. 136).

There is no present law credit for energy efficiency improvements to existing homes.

Reasons for change

Since residential energy consumption represents a large fraction of national energy use, the Committee believes that energy savings in this sector of the economy have the potential to significantly impact national energy consumption, which will reduce reliance on foreign suppliers of oil and reduce pollution in general. The Committee further recognizes that many existing homes are inadequately insulated. Accordingly, the Committee believes that a tax credit for certain energy-efficiency improvements related to a home's envelope (exterior windows (including skylights) and doors, insulation, and certain roofing systems) will encourage homeowners to improve the insulation of their homes, which in turn will reduce national energy consumption.

Explanation of Provision

The provision would provide a 10-percent nonrefundable credit for the purchase of qualified energy efficiency improvements. The maximum credit for a taxpayer with respect to the same dwelling for all taxable years is $300. A qualified energy efficiency improvement would be any energy efficiency building envelope component that is certified to meet or exceed the prescriptive criteria for such a component established by the 2000 International Energy Conservation Code, or any combination of energy efficiency measures that is certified to achieve at least a 30 percent reduction in heating and cooling energy usage for the dwelling and (1) that is installed in or on a dwelling located in the United States; (2) owned and used by the taxpayer as the taxpayer's principal residence; (3) the original use of which commences with the taxpayer; and (4) such component can reasonably be expected to remain in use for at least five years.

Building envelope components would be: (1) insulation materials or systems which are specifically and primarily designed to reduce the heat loss or gain for a dwelling, and (2) exterior windows (including skylights) and doors.

Homes shall be certified according to a component-based method or a performance-based method. The component-based method shall be based on applicable energy-efficiency ratings, including current product labeling requirements. Certification by the component method shall be provided by a third party, such as a local building regulatory authority, a utility, a manufactured home production inspection primary inspection agency, or a home energy rating organization.

The performance-based method shall be based on a comparison of the projected energy consumption of the dwelling in its original condition and after the completion of energy efficiency measures. The performance-based method of certification shall be conducted by an individual or organization recognized by the Secretary of the Treasury for such purposes.

The certification process requires that energy savings to the consumer be measured in terms of energy costs. To ensure consistent and reasonable energy cost analyses, the Department of Energy shall include in its rulemaking related to this bill specific reference data to be used for qualification for the credit.

The taxpayer's basis in the property would be reduced by the amount of the credit. Special rules would apply in the case of condominiums and tenant-stockholders in cooperative housing corporations.

The credit is allowed against the regular and alternative minimum tax.

Effective Date

The credit is effective for qualified energy efficiency improvements installed on or after the date of enactment and before January 1, 2007.

TITLE IV – CLEAN COAL INCENTIVES

A. Investment and Production Credits for Clean Coal Technology (secs. 401, 411, and 412 of the bill and new secs. 45I, 45J, and 48A of the Code)

Present Law

Present law does not provide an investment credit for electricity generating units that use coal as a fuel. Nor does present law provide a production credit for electricity generated at units that use coal as a fuel. However, a nonrefundable, 10-percent investment tax credit ("business energy credit") is allowed for the cost of new property that is equipment (1) that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) that is used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage (sec. 48). Also, an income tax credit is allowed for the production of electricity from either qualified wind energy, qualified "closed-loop" biomass, or qualified poultry waste units placed in service prior to January 1, 2004 (sec. 45). The credit allowed equals 1.5 cents per kilowatt-hour of electricity sold. The 1.5 cent figure is indexed for inflation and equaled 1.8 cents for 2002. The credit is allowable for production during the 10-year period after a unit is originally placed in service. The business energy tax credits and the production tax credit are components of the general business credit (sec. 38(b)(1)).

Reasons for Change

The Committee recognizes that coal is the nation's most abundant fuel source. The Committee is also sensitive to the environmental impact of burning coal for the production of electricity. For coal to continue to be a viable fuel source, the Committee seeks to encourage ways to burn coal in a more efficient and environmentally friendly manner. Therefore, the Committee supports the development and deployment of the most advanced technologies for generating electricity from coal by providing investment and production credits to a limited number of experimental production-scale electricity generating units to reduce the cost of building and operating units that represent the frontier of thermal efficiency and pollution control.

Tax-exempt organizations make up a significant percentage of the electricity industry in the United States. The Committee believes it is important to provide the incentives for investment in, and production from, clean coal technologies to all producers.

Explanation of Provision

In general

The bill creates three new credits: a production credit for electricity produced from qualifying clean coal technology units; a production credit for electricity produced from qualifying advanced clean coal technology units; and a credit for investments in qualifying advanced clean coal technology units. Certain persons (public utilities, electric cooperatives, Indian tribes, and the Tennessee Valley Authority) will be eligible to obtain certifications from the Secretary of the Treasury (as described below) for each of these credits and sell, trade, or assign the credit to any taxpayer. However, any credit sold, traded, or assigned may only be sold, traded, or assigned once. Subsequent transfers are not permitted.

<u>Credit for investments in qualifying advanced clean coal technology units</u>

The bill provides a 10-percent investment tax credit for qualified investments in advanced clean coal technology units. A qualified investment is that amount that would otherwise be a qualified investment multiplied by a fraction equal to the amount of national megawatt capacity allocated to the taxpayer (as described below) divided by the megawatt capacity of the qualifying unit. Qualifying advanced clean coal technology units must utilize advanced pulverized coal or atmospheric fluidized bed combustion technology, pressurized fluidized bed combustion technology, integrated gasification combined cycle technology, or some other technology certified by the Secretary of Energy. Any qualifying advanced clean coal technology unit must meet certain capacity standards, thermal efficiency standards, and emissions standards for SO_2, nitrous oxides, particulate emissions, and source emissions standards as provided in the Clean Air Act. In addition, a qualifying advanced clean coal technology unit must meet certain carbon emissions requirements.

The proposal defines four types of qualifying advanced clean coal technology units: (1) advanced pulverized coal or atmospheric fluidized bed combustion technology units (2) qualifying pressurized fluidized bed combustion technology units; (3) integrated gasification combined cycle technology units; and (3) other technology units.

(1) A qualifying advanced pulverized coal or atmospheric fluidized bed combustion technology unit is a unit placed in service after the date of enactment and before 2013 and having a design net heat rate of not more than 8,500 Btu (8,900 Btu if the unit is placed in service before 2009).

(2) A qualifying pressurized fluidized bed combustion technology unit is a unit placed in service after the date of enactment and before 2017 and having a design net heat rate of not more than 7,720 Btu (8,900 Btu if the unit is placed in service before 2009 and 8,500 Btu if the unit is placed in service after 2008 and before 2013).

(3) A qualifying integrated gasification combined cycle technology unit is a unit placed in service after the date of enactment and before 2017 and having a design net heat rate of not more than 7,720 Btu (8,900 Btu if the unit is placed in service before 2009 and 8,500 Btu if the unit is placed in service after 2008 and before 2013).

(4) A qualifying other technology unit use any other technology and is placed in service after the date of enactment and before 2017.

The provision provides that qualifying advanced clean coal units must satisfy carbon emissions standards. For units using design coal with a heat content of not more than 9,000 Btu per pound, the carbon emission rate must be less than 0.60 pound of carbon per kilowatt hour (0.51 if the unit qualifies as an other technology unit). For units using design coal with a heat content in excess of 9,000 Btu per pound, the carbon emission rate must be less than 0.54 pound of carbon per kilowatt hour (0.459 if the unit qualifies as an other technology unit).

To be a qualified investment in advanced clean coal technology, the taxpayer must receive a certificate from the Secretary of the Treasury. The Secretary may grant certificates to investments only to the point that 4,000 megawatts of electricity production capacity qualifies for the credit. From the potential pool of 4,000 megawatts of capacity, not more than 1,000 megawatts in total and not more than 500 megawatts in years prior to 2009 shall be allocated to units using advanced pulverized coal or atmospheric fluidized bed combustion technology. From the potential pool of 4,000 megawatts of capacity, not more than 500 megawatts in total and not more than 250 megawatts in years prior to 2009 shall be allocated to units using pressurized fluidized bed combustion technology. From the potential pool of 4,000 megawatts of capacity, not more than 2,000 megawatts in total and not more than 750 megawatts in years prior to 2009 shall be allocated to units using integrated gasification combined cycle technology, with or without fuel or chemical co-production. From the potential pool of 4,000 megawatts of capacity, not more than 500 in total and not more than 250 megawatts in years prior to 2009 shall be allocated to any other technology certified by the Secretary of Energy.

Production credit for electricity produced from qualifying clean coal technology units

The bill provides a production credit for electricity produced from certain units that have been retrofitted, repowered, or replaced with a clean coal technology within ten years of the date of enactment. The value of the credit is 0.34 cents per kilowatt-hour of electricity and the heat value of other fuels or chemicals produced at the unit[27] multiplied by the fraction equal to the amount of national megawatt capacity limitation (see below) allocated to the qualifying unit divided by the total megawatt capacity of the unit. The value of the credit is indexed for inflation occurring after 2003 with the first potential adjustment in 2005. The taxpayer may claim the credit throughout the ten-year period commencing from the date on which the qualifying unit is placed in service.

A qualifying clean coal technology unit is a clean coal technology unit that meets certain capacity standards, thermal efficiency standards, and emissions standards for SO_2, nitrous oxides, particulate emissions, and source emissions standards as provided in the Clean Air Act. In addition, a qualifying clean coal technology unit cannot be a unit that is receiving or is scheduled to receive funding under the Clean Coal Technology Program, the Power Plant Improvement Initiative, or the Clean Coal Power Initiative administered by the Secretary of the Department of Energy. Lastly, to be a qualified clean coal technology unit, the taxpayer must receive a certificate from the Secretary of the Treasury. The Secretary may grant certificates to units only to the point that 4,000 megawatts of electricity production capacity qualifies for the credit. However, no qualifying unit would be eligible if the unit's capacity exceeded 300 megawatts prior to having been retrofitted, repowered, or replaced. The maximum eligible allocation to any qualifying unit may not exceed 300 megawatts.

[27] Each 3,413 Btu of heat content of the fuel or chemical is treated as equivalent to one kilowatt-hour of electricity.

Production credit for electricity produced from qualifying advanced clean coal technology

The bill also provides a production credit for electricity produced from any qualified advanced clean coal technology electricity generation unit that qualifies for the investment credit for qualifying clean coal technology units, as described above.[28] The taxpayer may claim a production credit on the sum of each kilowatt-hour of electricity produced and the heat value of other fuels or chemicals produced by the taxpayer at the unit.[29] The taxpayer may claim the production credit for the 10-year period commencing with the date the qualifying unit is placed in service (or the date on which a conventional unit was retrofitted or repowered). The value of the credit varies depending upon the year the unit is placed in service, whether the unit produces solely electricity or electricity and fuels or chemicals, and the rated thermal efficiency of the unit.[30] In addition, the value of the credit is reduced for the second five years of eligible production. If a unit meets the more stringent qualification standards of post-2008 in years before 2009, the taxpayer may claim the higher post-2008 credit amounts. The value of the credit is indexed for inflation occurring after 2003 with the first potential adjustment in 2005. The tables below specify the value of the credit (before indexing is applied).

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[28] In the case of a taxpayer who received a megawatt allocation for a qualifying advanced clean coal technology unit that is less than the rated capacity of such unit, the taxpayer may claim credit on a percentage of the electricity produced from the unit. The percentage is the percentage that the taxpayer's megawatt allocation represents as a percentage of the rated capacity of the unit.

[29] Each 3,413 Btu of heat content of the fuel or chemical is treated as equivalent to one kilowatt-hour of electricity.

[30] Some of the tables in the bill, and below, express the unit's efficiency in terms of the units net heat rate and other tables express the unit's efficiency in percentage term. In practice, there is no difference as one kilowhatt-hour of electricity generally is equivalent to 3,413 Btu of heat. Therefore, if one divides 3,413 Btu by the efficiency rate one obtains the heat rate. Likewise, given a heat rate, the one calculates the efficiency by dividing 3,413 Btu by the heat rate.

Advanced clean coal technology units producing solely electricity

Table 11.–Units Placed in Service Before 2009

The unit net heat rate, Btu/kWh adjusted for the heat content for the design coal is equal to:	Credit amount per kilowatt-hour	
	For the first five years	For the second five years
Not more than 8,500	$.0060	$.0038
More than 8,500 but not more than 8,750	$.0025	$.0010
More than 8,750 but less than 8,900	$.0010	$.0010

Table 12.–Units Placed in Service After 2008 and Before 2013

The unit net heat rate, Btu/kWh adjusted for the heat content for the design coal is equal to:	Credit amount per kilowatt-hour	
	For the first five years	For the second five years
Not more than 7,770	$.0105	$.0090
More than 7,770 but not more than 8,125	$.0085	$.0068
More than 8,125 but less than 8,500	$.0075	$.0055

Table 13.–Units Placed in Service After 2012 and Before 2017

The unit net heat rate, Btu/kWh adjusted for the heat content for the design coal is equal to:	Credit amount per kilowatt-hour	
	For the first five years	For the second five years
Not more than 7,380	$.0140	$.0115
More than 7,380 but not more than 7,720	$.0120	$.0090

Advanced clean coal technology units producing electricity and a fuel or chemical

Table 14.–Units Placed in Service Before 2009

The unit design net thermal efficiency is equal to:	Credit amount per kilowatt-hour	
	For the first five years	For the second five years
Not less than 40.6%	$.0060	$.0038
Less than 40.6% but not less than 40%	$.0025	$.0010
Less than 40% but not less than 38.4%	$.0010	$.0010

Table 15.–Units Placed in Service After 2008 and Before 2013

The unit design net thermal efficiency is equal to:	Credit amount per kilowatt-hour	
	For the first five years	For the second five years
Not less than 43.6%	$.0105	$.0090
Less than 43.6% but not less than 42%	$.0085	$.0068
Less than 42% but not less than 40.2%	$.0075	$.0055

Table 16.–Units Placed in Service After 2012 and Before 2017

The unit design net thermal efficiency is equal to:	Credit amount per kilowatt-hour	
	For the first five years	For the second five years
Not less than 44.2%	$.0140	$.0115
Less than 44.2% but not less than 43.9%	$.0120	$.0090

The credits are part of the general business credit. No credit may be carried back to taxable years ending on or before the date of enactment.

Effective Date

The provision relating to investment credits for advanced clean coal technology units is effective after the date of enactment. The provisions relating to production credits are effective after the date of enactment.

TITLE V – OIL AND GAS PROVISIONS

A. Tax Credit for Oil and Gas Production from Marginal Wells (sec. 501 of the bill and sec. 45K of the Code)

Present Law

There is no credit for the production of oil and gas from marginal wells. The costs of such production may be recovered under the Code's depreciation and depletion rules and in other cases as a deduction for ordinary and necessary business expenses.

Reasons for Change

The highly volatile price of oil and gas can result in lost production during periods when prices are low. The Committee has learned that once a marginally producing well is shut down, that source of supply may be forever lost. To increase domestic supply, the Committee determined that a tax credit will help ensure that supply is not lost as a result of low market prices.

Explanation of Provision

The provision would create a new, $3 per barrel credit for qualified crude oil production and a $0.50 credit per 1,000 cubic feet of qualified natural gas production. The maximum amount of production on which credit could be claimed is 1,095 barrels or barrel equivalents. In both cases, the credit is available only for qualified production from a "qualified marginal well." The credit is not available to production occurring if the reference price of oil exceeded $18 ($2.00 for natural gas). The credit is reduced proportionately as for reference prices between $15 and $18 ($1.67 and $2.00 for natural gas). Reference prices are determined on a one-year look-back basis.

The terms "qualified crude oil production" and "qualified natural gas production" mean domestic crude oil or natural gas which is produced from a qualified marginal well. Production from a marginal well that is not in compliance with the applicable Federal pollution prevention, control and permit requirements for any period of time is not considered qualified crude oil production or qualified natural gas production. A qualified marginal well is defined as (1) a well production from which was marginal production for purposes of the Code percentage depletion rules or (2) a well that during the taxable year had (a) average daily production of not more than 25 barrel equivalents and (b) produced water at a rate of not less than 95 percent of total well effluent.

The credit is treated as part of the general business credit. The credit cannot be carried back to a taxable year ending on or before the date of enactment of the provision.

Effective Date

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

B. Natural Gas Gathering Lines Treated as Seven-Year Property (sec. 502 of the bill and sec. 168 of the Code)

Present Law

The applicable recovery period for assets placed in service under the Modified Accelerated Cost Recovery System is based on the "class life of the property." The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.[31] Revenue Procedure 87-56 includes two asset classes that could describe natural gas gathering lines owned by nonproducers of natural gas. Asset class 46.0, describing pipeline transportation, provides a class life of 22 years and a recovery period of 15 years. Asset class 13.2, describing assets used in the exploration for and production of petroleum and natural gas deposits, provides a class life of 14 years and a depreciation recovery period of seven years. The uncertainty regarding the appropriate recovery period of natural gas gathering lines has resulted in litigation between taxpayers and the IRS. The 10th Circuit Court of Appeals held that natural gas gathering lines owned by nonproducers falls within the scope of Asset class 13.2 (i.e., seven-year recovery period).[32] More recently, the Tax Court and the U.S. District Court for the Eastern District of Michigan, Southern Division, held that natural gas gathering lines owned by nonproducers falls within the scope of Asset class 46.0 (*i.e.*, 15-year recovery period).[33]

Reasons For Change

The Committee believes the appropriate recovery period for natural gas gathering lines is seven years.

Explanation of Provision

The provision establishes a statutory seven-year recovery period and a class life of 10 years for natural gas gathering lines. A natural gas gathering line is defined to include any pipe, equipment, and appurtenance that is (1) determined to be a gathering line by the Federal Energy Regulatory Commission, or (2) used to deliver natural gas from the wellhead or a common point to the point at which such gas first reaches (a) a gas processing plant, (b) an interconnection with an interstate transmission line, (c) an interconnection with an intrastate transmission line, or (d) a direct interconnection with a local distribution company, a gas storage facility, or an industrial consumer.

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[31] 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

[32] *Duke Energy v. Commissioner*, 172 F.3d 1255 (10th Cir. 1999), *rev'g* 109 T.C. 416 (1997). See also *True v. United States*, 97-2 U.S. Tax Cas. (CCH) par. 50,946 (D. Wyo. 1997).

[33] *Clajon Gas Co., L.P. v. Commissioner*, 119 T.C. 197 (2002) and *Saginaw Bay Pipeline Co. v. United States*, 124 F. Supp. 2d 465 (E.D. Mich. 2001).

Effective Date

The provision is effective for property placed in service after the date of enactment. No inference is intended as to the proper treatment of natural gas gathering lines placed in service before the date of enactment.

C. Expensing of Capital Costs Incurred and Credit for Production in Complying with Environmental Protection Agency Sulfur Regulations (secs. 503 and 504 of the bill and new secs. 179C and 45L of the Code)

Present Law

Taxpayers generally may recover the costs of investments in refinery property through annual depreciation deductions. Present law does not provide a credit for the production of low-sulfur diesel fuel.

Reasons for Change

The Committee believes it is important for all refiners to meet applicable pollution control standards. However, the Committee is concerned that the cost of complying with the Highway Diesel Fuel Sulfur Control Requirement of the Environmental Protection Agency may force some small refiners out of business. To maintain this refining capacity and to foster compliance with pollution control standards the Committee believes it is appropriate to modify cost recovery provisions for small refiners to reduce their capital costs of complying with the Highway Diesel Fuel Sulfur Control Requirement of the Environmental Protection Agency.

Explanation of Provision

The provision generally permits small business refiners to claim an immediate deduction (i.e., expensing) for up to 75 percent of the qualified capital costs paid or incurred for the purpose of complying with the Highway Diesel Fuel Sulfur Control Requirements of the Environmental Protection Agency. Qualified capital costs are those costs paid or incurred and otherwise chargeable to the taxpayer's capital account that are necessary for the refinery to come into compliance with the EPA diesel fuel requirements.

In addition, the provision provides that a small business refiner may claim a credit equal to five cents per gallon for each gallon of low sulfur diesel fuel produced at a facility of a small business refiner. The total production credit claimed by the taxpayer generally is limited to 25 percent of the qualified capital costs incurred with respect to expenditures at the refinery during the period beginning after the date of enactment and ending with the date that is one year after the date on which the taxpayer must comply with applicable EPA regulations. No deduction is allowed to the taxpayer for expenses otherwise allowable as a deduction in an amount equal to the amount of production credit claimed during the taxable year.

For these purposes a small business refiner is a taxpayer who within the business of refining petroleum products employs not more than 1,500 employees directly in refining on business days during a taxable year in which the deduction or production credit is claimed and had an average daily refinery run (or retained production) not exceeding 205,000 barrels per day[34] for the year prior to enactment.

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[34] The refining capacities of all persons that are part of a related group are aggregated for purposes of this definition. In addition, in any case where refinery through-put or retained

For taxpayers with an average daily refinery run in the year prior to enactment in excess of 155,000 and not greater than 205,000 barrels per day, the provision limits otherwise qualifying small business refiners to an immediate deduction for a percentage of qualifying capital costs equal to 75 percent less the percentage points determined by the excess of the average daily refinery runs over 155,000 barrels per day divided by 50,000 barrels per day. In addition, for these taxpayers, the limitation on the total production credit that may be claimed also is reduced proportionately.

In the case of a qualifying small business refiner that is owned by a cooperative, the cooperative is allowed to elect to pass any production credits to patrons of the organization.

Effective Date

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

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production of the refinery differs substantially from its average daily output of refined product, the Committee intends that capacity be measured by reference to the average daily output of refined product.

D. Determination of Small Refiner Exception to Oil Depletion Deduction (sec. 505 of the bill and sec. 613A of the Code)

Present Law

Present law classifies oil and gas producers as independent producers or integrated companies. The Code provides numerous special tax rules for operations by independent producers. One such rule allows independent producers to claim percentage depletion deductions rather than deducting the costs of their asset, a producing well, based on actual production from the well (i.e., cost depletion).

A producer is an independent producer only if its refining and retail operations are relatively small. For example, an independent producer may not have refining operations the runs from which exceed 50,000 barrels on any day in the taxable year during which independent producer status is claimed.

Reasons for Change

The Committee believes that the goal of present law, to identify producers without significant refining capacity, can be achieved while permitting more flexibility to refinery operations.

Explanation of Provision

The provision increases the current 50,000-barrel-per-day limitation to 60,000. In addition, the provision changes the refinery limitation on claiming independent producer status from a limit based on actual daily production to a limit based on average daily production for the taxable year. Accordingly, the average daily refinery run for the taxable year cannot exceed 60,000 barrels. For this purpose, the taxpayer calculates average daily refinery run by dividing total production for the taxable year by the total number of days in the taxable year.

Effective Date

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

E. Extension of Suspension of Taxable Income Limit With Respect to Marginal Production (sec. 506 of the bill and sec. 613A of the Code)

Present Law

In general

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.[35] 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 economic or pecuniary advantage derived from production through a contractual relation.

Cost depletion

Two methods of depletion are currently allowable under the Internal Revenue Code (the "Code"): (1) the cost depletion method, and (2) the percentage depletion method (secs. 611-613). 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.[36] 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 (sec. 613A(c)). The amount deducted generally may not exceed 100 percent of the net income from that property in any year (the "net-income limitation") (sec.

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[35] Treas. Reg. sec. 1.611-1(b)(1).

[36] Sec. 613A.

613(a)). By contrast, for any other mineral qualifying for the percentage depletion deduction, such deduction may not exceed 50 percent of the taxpayer's taxable income from the depletable property. A similar 50-percent net-income limitation applied to oil and gas properties for taxable years beginning before 1991. Section 11522(a) of the Omnibus Budget Reconciliation Act of 1990 prospectively changed the net-income limitation threshold to 100 percent only for oil and gas properties, effective for taxable years beginning after 1990. 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.

Additionally, the percentage depletion deduction for all oil and gas properties may not exceed 65 percent of the taxpayer's overall taxable income (determined before such deduction and adjusted for certain loss carrybacks and trust distributions) (sec. 613A(d)(1)).[37] Because percentage depletion, unlike cost depletion, is computed without regard to the taxpayer's basis in the depletable property, cumulative depletion deductions may be greater than the amount expended by the taxpayer to acquire or develop the property.

A taxpayer is required to determine the depletion deduction for each oil or gas property under both the percentage depletion method (if the taxpayer is entitled to use this method) and the cost depletion method. If the cost depletion deduction is larger, the taxpayer must utilize that method for the taxable year in question (sec. 613(a)).

Limitation of oil and gas percentage depletion to independent producers and royalty owners

Generally, only independent producers and royalty owners (as contrasted to integrated oil companies) are allowed to claim percentage depletion. Percentage depletion for eligible taxpayers is allowed only with respect to up to 1,000 barrels of average daily production of domestic crude oil or an equivalent amount of domestic natural gas (sec. 613A(c)). For producers of both oil and natural gas, this limitation applies on a combined basis.

In addition to the independent producer and royalty owner exception, certain sales of natural gas under a fixed contract in effect on February 1, 1975, and certain natural gas from geopressured brine,[38] are eligible for percentage depletion, at rates of 22 percent and 10 percent, respectively. These exceptions apply without regard to the 1,000-barrel-per-day limitation and regardless of whether the producer is an independent producer or an integrated oil company.

Reasons for Change

The Committee is concerned that, while current oil and gas operations may be profitable, the highly volatile nature of oil and gas prices could quickly create economic hardships in the industry. Thus, to help minimize the adverse effects of future price fluctuations, the Committee

[37] Amounts disallowed as a result of this rule may be carried forward and deducted in subsequent taxable years, subject to the 65-percent taxable income limitation for those years.

[38] This exception is limited to wells, the drilling of which began between September 30, 1978, and January 1, 1984.

believes it is appropriate to extend the suspension of the 100-percent net-income limitation for marginal wells.

Explanation of Provision

The suspension of the 100-percent net-income limitation for marginal wells is extended through taxable years beginning before January 1, 2007.

Effective Date

The provision is effective on date of enactment.

F. Amortization of Delay Rental Payments
(sec. 507 of the bill and new sec. 199A of the Code)

Present Law

Present law generally requires costs associated with inventory and property held for resale to be capitalized rather than currently deducted as they are incurred. (sec. 263). Oil and gas producers typically contract for mineral production in exchange for royalty payments. If mineral production is delayed, these contracts provide for "delay rental payments" as a condition of their extension. In proposed regulations issued in 2000, the Treasury Department took the position that the uniform capitalization rules of section 263A require delay rental payments to be capitalized.[39]

Reasons for Change

The Committee believes that substantial simplification for taxpayers and significant gains in taxpayer compliance and reductions in administrative cost can be contained by establishing the simple rule that all delay rental payments may be amortized over two years, including the basis of abandoned property.

Explanation of Provision

The provision allows delay rental payments incurred in connection with the development of oil or gas within the United States to be amortized over two years. In the case of abandoned property, remaining basis may no longer be recovered in the year of abandonment of a property as all basis is recovered over the two-year amortization period.

Effective Date

The provision applies to delay rental payments paid or incurred in taxable years beginning after the date of enactment. No inference is intended from the prospective effective date of this proposal as to the proper treatment of pre-effective date delay rental payments.

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[39] 65 Fed. Reg. 6090 (2000).

G. Amortization of Geological and Geophysical Expenditures (sec. 508 of the bill and new sec. 199 of the Code)

Present Law

In general

Geological and geophysical expenditures are costs incurred by a taxpayer for the purpose of obtaining and accumulating data that will serve as the basis for the acquisition and retention of mineral properties by taxpayers exploring for minerals. A key issue with respect to the tax treatment of such expenditures is whether or not they are capital in nature. Capital expenditures are not currently deductible as ordinary and necessary business expenses, but are allocated to the cost of the property.[40]

Courts have held that geological and geophysical costs are capital, and therefore are allocable to the cost of the property[41] acquired or retained.[42] The costs attributable to such exploration are allocable to the cost of the property acquired or retained. As described further below, IRS administrative rulings have provided further guidance regarding the definition and proper tax treatment of geological and geophysical costs.

Revenue Ruling 77-188

In Revenue Ruling 77-188[43] (hereinafter referred to as the "1977 ruling"), the IRS provided guidance regarding the proper tax treatment of geological and geophysical costs. The ruling describes a typical geological and geophysical exploration program as containing the following elements:

- It is customary in the search for mineral producing properties for a taxpayer to conduct an exploration program in one or more identifiable project areas. Each

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[40] Under section 263, capital expenditures are defined generally as any amount paid for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. Treasury regulations define capital expenditures to include amounts paid or incurred (1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer or (2) to adapt property to a new or different use. Treas. Reg. sec. 1.263(a)-1(b).

[41] "Property" means an interest in a property as defined in section 614 of the Code, and includes an economic interest in a tract or parcel of land notwithstanding that a mineral deposit has not been established or proved at the time the costs are incurred.

[42] See, *e.g., Schermerhorn Oil Corporation v. Commissioner,* 46 B.T.A. 151 (1942). By contrast, section 617 of the Code permits a taxpayer to elect to deduct certain expenditures incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral (but not oil and gas). These deductions are subject to recapture if the mine with respect to which the expenditures were incurred reaches the producing stage.

[43] 1977-1 C.B. 76.

project area encompasses a territory that the taxpayer determines can be explored advantageously in a single integrated operation. This determination is made after analyzing certain variables such as (1) the size and topography of the project area to be explored, (2) the existing information available with respect to the project area and nearby areas, and (3) the quantity of equipment, the number of personnel, and the amount of money available to conduct a reasonable exploration program over the project area.

- The taxpayer selects a specific project area from which geological and geophysical data are desired and conducts a reconnaissance-type survey utilizing various geological and geophysical exploration techniques. These techniques are designed to yield data that will afford a basis for identifying specific geological features with sufficient mineral potential to merit further exploration.

- Each separable, noncontiguous portion of the original project area in which such a specific geological feature is identified is a separate "area of interest." The original project area is subdivided into as many small projects as there are areas of interest located and identified within the original project area. If the circumstances permit a detailed exploratory survey to be conducted without an initial reconnaissance-type survey, the project area and the area of interest will be coextensive.

- The taxpayer seeks to further define the geological features identified by the prior reconnaissance-type surveys by additional, more detailed, exploratory surveys conducted with respect to each area of interest. For this purpose, the taxpayer engages in more intensive geological and geophysical exploration employing methods that are designed to yield sufficiently accurate sub-surface data to afford a basis for a decision to acquire or retain properties within or adjacent to a particular area of interest or to abandon the entire area of interest as unworthy of development by mine or well.

The 1977 ruling provides that if, on the basis of data obtained from the preliminary geological and geophysical exploration operations, only one area of interest is located and identified within the original project area, then the entire expenditure for those exploratory operations is to be allocated to that one area of interest and thus capitalized into the depletable basis of that area of interest. On the other hand, if two or more areas of interest are located and identified within the original project area, the entire expenditure for the exploratory operations is to be allocated equally among the various areas of interest.

If no areas of interest are located and identified by the taxpayer within the original project area, then the 1977 ruling states that the entire amount of the geological and geophysical costs related to the exploration is deductible as a loss under section 165. The loss is claimed in the taxable year in which that particular project area is abandoned as a potential source of mineral production.

A taxpayer may acquire or retain a property within or adjacent to an area of interest, based on data obtained from a detailed survey that does not relate exclusively to any discrete property within a particular area of interest. Generally, under the 1977 ruling, the taxpayer allocates the entire amount of geological and geophysical costs to the acquired or retained property as a capital cost under section 263(a). If more than one property is acquired, it is proper to determine the amount of the geological and geophysical costs allocable to each such property by allocating the entire amount of the costs among the properties on the basis of comparative acreage.

If, however, no property is acquired or retained within or adjacent to that area of interest, the entire amount of the geological and geophysical costs allocable to the area of interest is deductible as a loss under section 165 for the taxable year in which such area of interest is abandoned as a potential source of mineral production.

In 1983, the IRS issued Revenue Ruling 83-105,[44] which elaborates on the positions set forth in the 1977 ruling by setting forth seven factual situations and applying the principles of the 1977 ruling to those situations. In addition, Revenue Ruling 83-105 explains what constitutes "abandonment as a potential source of mineral production."

Reasons for Change

The Committee believes that substantial simplification for taxpayers, significant gains in taxpayer compliance, and reductions in administrative cost can be obtained by establishing the simple rule that all geological and geophysical costs may be amortized over two years, including the basis of abandoned property.

The Committee recognizes that, on average, a two-year amortization period accelerates recovery of geological and geophysical expenses. The Committee believes that more rapid recovery of such expenses will foster increased exploration for new sources of supply.

Explanation of Provision

The provision allows geological and geophysical costs incurred in connection with oil and gas exploration in the United States to be amortized over two years. In the case of abandoned property, remaining basis may no longer be recovered in the year of abandonment of a property as all basis is recovered over the two-year amortization period.

Effective Date

The provision is effective for geological and geophysical costs paid or incurred in taxable years beginning after the date of enactment. No inference is intended from the prospective effective date of this proposal as to the proper treatment of pre-effective date geological and geophysical costs.

[44] 1983-2 C.B. 51.

H. Extension and Modification of Credit for Producing Fuel From a Non-Conventional Source (sec. 509 of the bill and new sec. 45J of the Code)

Present Law

Certain fuels produced from "non-conventional sources" and sold to unrelated parties are eligible for an income tax credit equal to $3 (generally adjusted for inflation)[45] per barrel or BTU oil barrel equivalent (sec. 29). Qualified fuels must be produced within the United States.

Qualified fuels include:

(5) oil produced from shale and tar sands; as produced from geopressured brine, Devonian shale, coal seams, tight formations ("tight sands"), or biomass; and

(6) liquid, gaseous, or solid synthetic fuels produced from coal (including lignite).

In general, the credit is available only with respect to fuels produced from wells drilled or facilities placed in service after December 31, 1979, and before January 1, 1993. An exception extends the January 1, 1993 expiration date for facilities producing gas from biomass and synthetic fuel from coal if the facility producing the fuel is placed in service before July 1, 1998, pursuant to a binding contract entered into before January 1, 1997.

The credit may be claimed for qualified fuels produced and sold before January 1, 2003 (in the case of non-conventional sources subject to the January 1, 1993 expiration date) or January 1, 2008 (in the case of biomass gas and synthetic fuel facilities eligible for the extension period).

Reasons for Change

The Committee concludes that the section 29 credit, on the margins, has increased production of oil and natural gas from domestic sources and that in the absence of these non-conventional sources the demand for imported fuels may have increased. To increase domestic sources of supply, the Committee believes it is appropriate to extend the section 29 credit to help foster new domestic fuel sources. The Committee is also concerned that, without the implicit subsidy of the production credit due to the higher extraction costs of certain "viscous oil," entrepreneurs would not otherwise exploit this domestic energy source. Therefore, the Committee believes it is appropriate to extend the credit for viscous oil produced from new wells or facilities.

The Committee also recognizes that the credit for production of synthetic fuels from coal has been interpreted to include fuels that are merely chemical changes to coal that do not necessarily enhance the value or environmental performance of the feedstock coal. Therefore, the Committee believes it is appropriate to extend the section 29 credit only to fuels produced

[45] The value of the section 29 credit for production in 2002 was $6.35 per barrel of oil equivalent.

from coal that achieve significant environmental and value-added improvements. Methane in coal mines is a serious safety hazard. In many coal mining operations, the cost of collection exceeds the value of the recovered methane so the methane is vented directly into the atmosphere. Methane is an extremely potent and long-lived greenhouse gas. Therefore, the Committee seeks to encourage capture of methane from coal mines in particular.

The Committee recognizes that the world price of oil as the nation enters the 21st century has not risen to levels forecast in 1978. Therefore, the Committee believes it is appropriate to restart the section 29 credit at a level lower than that currently available to existing production.

The Committee believes it is important to study the efficacy of the section 29 credit in the case of methane recovered from coal seams or so-called "coal beds."

Explanation of Provision

The provision extends the placed in service date for certain facilities that would otherwise qualify for the section 29 credit under present law and modifies the amount of the credit to equal $3.00 unindexed for inflation. The provision also expands the class of facilities that are eligible for the credit. In addition, under the provision, the taxpayer would not be able to claim any credit for production in excess of a daily average of 200,000 cubic feet of gas (or barrel of oil equivalent) from a qualifying well or facility.[46]

Clarification of definition of when a facility is placed in service

The provision clarifies the definition of when a landfill gas facility is placed in service, both for facilities originally placed in service on or before the date of enactment and for facilities placed in service after the date of enactment. In general, a landfill gas facility includes wells, pipes, and the related components to collect landfill gas (i.e., the gas produced from biomass and derived from the bio-degradation on municipal solid waste). The production of landfill gas attributable to wells, pipes, and related components placed in service after the date of enactment is considered produced from a facility placed in service after the date of enactment. Production of landfill gas attributable to those wells, pipes, and related components placed in service on or before the date of enactment is considered produced from a facility placed in service on or before the date of enactment. That is, all of the landfill gas produced from a landfill is not considered to be from a facility placed in service on the date on which the first set of wells, pipes, and related components drew gas from the landfill. Rather, as a landfill expands and additional integrated sets of wells, pipes, and related components are installed to draw off landfill gas, the landfill gas drawn from each additional integrated set of wells, pipes, and related components is to be considered to be produced from a facility placed in service on the date each additional integrated set of wells, pipes, and related components is placed in service. Thus, a single landfill may have several "facilities" eligible for the section 29 credit, each placed in service on a different date.

[46] The daily average would be computed as total production divided by the total number of days the well or facility was in production during the year.

Extension for certain non-conventional fuels

The provision permits taxpayers to claim the section 29 credit for production of certain non-conventional fuels produced at wells placed in service after the date of enactment and before January 1, 2007.[47] Under the provision, qualifying fuels are oil from shale or tar sands, and gas from geopressured brine, Devonian shale, coal seams, a tight formation, or biomass. The value of the credit is re-based to $3.00 and the amount is not indexed for inflation. Taxpayers may claim the credit for production from the well for each of the first three years of production from the qualifying well.

Expansion for fuels from agricultural and animal waste

The provision adds facilities producing liquid, gaseous, or solid fuels, from agricultural and animal waste placed in service after the date of enactment and before January 1, 2007, to the list of qualified facilities for purposes of the non-conventional fuel credit. The amount of the credit is equal to $3.00 (unindexed) per barrel or Btu oil barrel equivalent, for three years of production commencing on the date the facility is placed in service. Agricultural and animal waste includes by-products, packaging, and any materials associated with processing, feeding, selling, transporting, or disposal of agricultural or animal products or wastes.

Expansion for "viscous oil"

The provision expands section 29 to permit taxpayers to claim the section 29 credit for production of certain viscous oil produced at wells placed in service after the date of enactment and before January 1, 2007. The provision defines "viscous oil" as domestic crude oil produced from any property if the crude oil has a weighted average gravity of 22 degrees API or less (corrected to 60 degrees Fahrenheit). The value of the credit for viscous oil also is $3.00 per barrel. Taxpayers may claim the credit for production from the well for each of the first three years of production from the time the well is placed in service. The provision provides that qualifying sales to related parties for consumption not in the immediate vicinity of the wellhead qualify for the credit.

Expansion for "refined coal"

The provision also expands section 29 to include certain "refined coal" as a qualified non-conventional fuel. "Refined coal" is a qualifying liquid, gaseous, or solid synthetic fuel produced from coal (including lignite) from facilities placed in service after date of enactment and before January 1, 2007. Refined coal also would include a qualifying fuel derived from high-carbon fly ash produced from facilities placed in service after the date of enactment and before January 1, 2007.[48] A qualifying fuel is a fuel that when burned emits 20 percent less

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[47] The provision does not apply to liquid, gaseous, or solid synthetic fuels produced from coal as described under present law section 29(c)(1)(C), but does provide credit for a new category, refined coal, described below.

[48] No inference is intended that high-carbon fly ash qualified previous to the date of enactment.

nitrogen oxide and either sulfur dioxide or mercury than the burning of feedstock coal or comparable coal predominantly available in the marketplace as of January 1, 2003, and if the fuel sells at prices at least 50 percent greater than the prices of the feedstock coal or comparable coal. However, no fuel produced at a qualifying advanced clean coal facility (as defined elsewhere in the committee bill) would be a qualifying fuel. The amount of credit for refined coal also is $3.00 per barrel equivalent. Taxpayers may claim the credit for fuel produced during the five-year period beginning on the date the facility is placed in service.

Expansion for coalmine gas

In addition, the provision permits taxpayers to claim credit for coalmine gas captured by the taxpayer and utilized as a fuel source or sold by or on behalf of the taxpayer to an unrelated person. The term "coalmine gas" means any methane gas which is being liberated during qualified coal mining operations or as a result of past qualified coal mining operations, or which is captured 10 years in advance of qualified coal mining operations as part of specific plan to mine a coal deposit. In the case of coalmine gas that is captured in advance of qualified coal mining operations, the credit is allowed only after the date the coal extraction occurs in the immediate area where the coalmine gas was removed. The value of the credit for coalmine methane also is $3.00 per Btu oil barrel equivalent (51.7 cents per million Btu of heat value in the gas) for gas captured and utilized or sold. Taxpayers may claim the credit for gas captured and utilized or sold after the date of enactment and before January 1, 2007.

Extension of credit for certain existing facilities

The provision extends the present-law credit through December 31, 2005 for production from existing facilities producing coke, coke gas, or natural gas and by-products produced by coal gasification from lignite. The provision provides that the credit amount will be $3.00 per Btu oil barrel equivalent for production from such facilities after December 31, 2002.

Study of coal bed methane gas

Lastly, the provision directs the Secretary of the Treasury to undertake a study of the effect section 29 has had on the production of coal bed methane. The study should estimate the total amount of credit claimed annually and in aggregate related to the production of coal bed methane since the enactment of section 29. The study should report the annual value of the credit allowable for coal bed methane compared to the average annual wellhead price of natural gas (per thousand cubic feet of natural gas). The study should estimate the incremental increase in production of coal bed methane that has resulted from the enactment of section 29. The study should estimate the cost to the Federal government, in terms of the net tax benefits claimed, per thousand cubic feet of incremental coal bed methane produced annually and in aggregate since the enactment of section 29.

Effective Date

The provisions apply to fuels sold from qualifying wells and facilities after the date of enactment.

I. Natural Gas Distribution Lines Treated as 15-Year Property (sec. 510 of the bill and sec. 168 of the Code)

Present Law

The applicable recovery period for assets placed in service under the Modified Accelerated Cost Recovery System is based on the "class life of the property." The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.[49] Natural gas distribution pipelines are assigned a 20-year recovery period and a class life of 35 years.

Reasons for Change

The Committee recognizes the importance of modernizing our aging energy infrastructure to meet the demands of the twenty-first century, and the Committee also recognizes that both short-term and long-term solutions are required to meet this challenge. The Committee understands that investment in our energy infrastructure has not kept pace with the nation's needs. In light of this, the Committee believes it is appropriate to reduce the recovery period for investment in certain energy infrastructure property to encourage investment in such property.

Explanation of Provision

The provision establishes a statutory 15-year recovery period and a class life of 20 years for natural gas distribution lines.

Effective Date

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

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[49] 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

J. Credit for Alaska Natural Gas (sec. 511 of the bill and new sec. 45M of the Code)

Present Law

Present law does not provide a credit for conventional production of natural gas or delivery of fuels to a pipeline. However, certain fuels produced from "non-conventional sources" and sold to unrelated parties are eligible for an income tax credit equal to $3 (generally adjusted for inflation) per barrel or BTU oil barrel equivalent (sec. 29). Qualified fuels must be produced within the United States.

Qualified fuels include:

(1) gas produced from geopressured brine, Devonian shale, coal seams, tight formations ("tight sands"), or biomass; and

(2) liquid, gaseous, or solid synthetic fuels produced from coal (including lignite).

In general, the credit is available only with respect to fuels produced from wells drilled or facilities placed in service after December 31, 1979, and before January 1, 1993. An exception extends the January 1, 1993 expiration date for facilities producing gas from biomass and synthetic fuel from coal if the facility producing the fuel is placed in service before July 1, 1998, pursuant to a binding contract entered into before January 1, 1997.

The credit may be claimed for qualified fuels produced and sold before January 1, 2003 (in the case of non-conventional sources subject to the January 1, 1993 expiration date) or January 1, 2008 (in the case of biomass gas and synthetic fuel facilities eligible for the extension period).

Reasons for Change

The Committee recognizes the natural gas in Alaska is an important natural resource that can expand domestic energy supplies. However, due to the volatility of energy prices, the private sector may be unwilling to make the substantial investment in a pipeline to bring some of the natural gas to the lower 48 States. The Committee believes it is important to make this natural gas resource available to the lower 48 States and to provide an economic stimulus to the Alaskan economy. The Committee believes that a credit against income taxes for delivery of natural gas to a transmission pipeline will provide a minimum return and the reduced volatility necessary to induce the private sector to invest in the pipeline to bring Alaska natural gas to the rest of the U.S. market.

Explanation of Provision

The provision provides a credit per million British thermal units (Btu) of natural gas for Alaska natural gas entering a pipeline[50] during the 15-year period beginning the later of January 1, 2010 or the initial date for the interstate transportation of Alaska natural gas. Taxpayers may claim the credit against both the regular and minimum tax.

The credit amount for any month is a maximum of 52 cents per million Btu of natural gas. The credit phases out as the reference price of Alaska natural gas rises above 83 cents per million Btu, at a rate of one cent of credit lost per each cent by which the reference price of Alaska natural gas exceeds 83 cents per million Btu. The credit is not available if the reference price of Alaska natural gas rises above $1.35 per million Btu. The 52-cent and 83-cent figures are indexed for inflation after 2002, with the first adjustment for calendar year 2004.[51]

The bill provides that the Secretary of Treasury calculate the reference price of Alaska natural gas as the average price of natural gas delivered in the lower 48 States less certain transportation costs and gas processing costs. The Committee intends that an appropriate measure of the price of natural gas delivered to the lower 48 States be the monthly Chicago city gate price for natural gas as reliably reported in one or more trade publications or as reported by the Secretary of Energy. Because qualifying natural gas is likely to be transported across both the United States and Canada, the Committee intends that transportation costs be measured as such costs as determined (pursuant to approved tariffs) by the appropriate national regulatory body. At the present time, the appropriate national regulatory body for transportation of natural gas in the United States is the Federal Energy Regulatory Commission. At the present time, the Committee understands the appropriate national regulatory body for transportation of natural gas in Canada is the Canadian National Energy Board. The Committee further intends that gas processing costs include all rates and charges of whatever kind for firm service assessed with respect to the processing of Alaska natural gas as calculated pursuant to approved tariffs under the Natural Gas Act (15 U.S.C. 717), if such costs are regulated by the Federal government, or as calculated under the principles of sec. 482 of the Code, if such costs are not regulated by the Federal government.

[50] Natural gas entering a gas processing facility is not considered to have entered a pipeline. Rather, the credit applies only to pipeline quality gas at the time of entry into the pipeline.

[51] In practice, the $1.35-figure also is indexed for inflation, as $1.35 is the sum of the 52-cent credit and the 83-cent price.

The bill provides that the Secretary can compute the inflation adjustment factor for a calendar year in the fourth quarter of the preceding year. For example, the adjustment for 2004 is calculated as the 2003 GDP deflator over the 2002 GDP deflator, where the 2002 GDP deflator is the value of the GDP deflator on June 30, 2002 (as determined by the latest available revision from the Department of Commerce prior to October 1, 2002). Likewise, the 2003 deflator is the value of the GDP deflator on June 30, 2003.

Alaska natural gas is any gas derived from an area of the State of Alaska lying north of 64 degrees North latitude, but not including the Alaska National Wildlife Refuge.

The credit is part of the general business credit.

Effective date

The proposal is effective on the date of enactment.

K. Certain Alaska Pipeline Systems Treated as Seven-Year Property (sec. 512 of the bill and sec. 168 of the Code)

Present Law

The applicable recovery period for assets placed in service under the Modified Accelerated Cost Recovery System is based on the "class life of the property." The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.[52] Assets used in the private, commercial, and contract carrying of petroleum, gas and other products by means of pipes and conveyors are assigned a 15-year recovery period and a class life of 22 years.

Reasons for Change

The Committee recognizes that, on our present course, the nation will be ever more reliant on foreign governments, that do not always have America's interest at heart, for oil and natural gas. The Committee recognizes that even with conservation efforts and alternative sources of energy that our nation's long-term security depends on reducing our reliance on foreign energy sources. In light of this, the Committee believes it is appropriate to reduce the recovery period, and thus the cost of capital, for investment in natural gas pipeline systems in Alaska that meet certain requirements.

Explanation of Provision

The provision establishes a statutory seven-year recovery period and a class life of 10 years for any natural gas pipeline system, located in Alaska, that has a capacity greater than five hundred billion Btu of natural gas per day and is placed in service after 2014. For purposes of the proposal, a natural gas pipeline system is defined as any system used in the carrying of natural gas by means of pipes, including pipe, trunk lines, related equipment, and appurtenances. It does not include any gas treatment plant related to such pipeline.

Effective Date

The proposal is effective on the date of enactment.

[52] 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

L. Exempt Certain Prepayments for Natural Gas From Tax-Exempt Bond Arbitrage Rules (sec. 513 of the bill and sec. 148 of the Code)

Present Law

Interest on bonds issued by States or local governments to finance activities carried out or paid for by those entities generally is exempt from income tax (sec. 103). Restrictions are imposed on the ability of States or local governments to invest the proceeds of these bonds for profit (the "arbitrage restrictions"). One such restriction limits the use of bond proceeds to acquire "investment-type property." A prepayment for property or services may give rise to investment-type property. A prepayment can produce prohibited arbitrage profits when the discount received for prepaying the costs exceeds the yield on the tax-exempt bonds. In general, prohibited prepayments include all prepayments that are not customary in an industry by both beneficiaries of tax-exempt bonds and other persons using taxable financing for the same transaction.

On April 17, 2002, the Department of the Treasury issued proposed regulations regarding arbitrage and private activity restrictions applicable to tax-exempt bonds issued by State and local governments. The proposed regulations add an exception to the definition of investment-type property for certain natural gas prepayments that are made by or for one or more utilities that are owned by a governmental person.[53] The exception applies if at least 95 percent of the natural gas purchased with the prepayment is to be (1) consumed by retail customers in the service area of a municipal gas utility, or (2) used to produce electricity that will be furnished to retail customers that a municipal electric utility is obligated to serve under State or Federal law. An obligation that arises solely because of a contract is not an obligation to serve under State or Federal law. For this purpose, the service area of a municipal gas utility is defined as (1) any area throughout which the municipal utility provided (at all times during the five-year period ending on the issue date) gas transmission or distribution service, and any area that is contiguous to such an area, or (2) any area where the municipal utility is obligated under State or Federal law to provide gas distribution services as provided in such law. Issuers may apply principles similar to the rules governing private use to cure a violation of the 95 percent requirement.[54]

A prepayment will not fail to meet the requirements for prepaid gas contracts by reason of any commodity swap contract that may be entered into between the issuer and an unrelated party (other than the gas supplier), or between the gas supplier and an unrelated party (other than the issuer), so long as each swap contract is an independent contract. A swap contract is an independent contract if the obligation of each party to perform under the swap contract is not dependent on performance by any person (other than the other party to the swap contract) under another contract (for example, a gas contract or another swap contract). A natural gas commodity swap contract will not fail to be an independent contract solely because the swap contract may terminate in the event of a failure of a gas supplier to deliver gas for which the

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[53] Prop. Treas. Reg. sec. 1.148-1(e)(2)(ii).

[54] *See* Treas. Reg. 1.141-12.

swap contract is a hedge.[55] The Commissioner may, by published guidance, set forth additional circumstances in which a prepayment does not give rise to investment-type property.

Reasons for Change

The Committee determined that it was appropriate to complement the proposed Treasury regulations with a safe harbor that provides certainty on the date of issuance that prepayments for natural gas within the safe harbor will not violate the arbitrage rules. This provision will ensure adequate supplies of natural gas at predictable prices for natural gas utility customers without sacrificing to a great degree the appropriate present-law limitations regarding tax-exempt bond issuance for the purchase of investment property. The Committee believes that this proposal strikes an appropriate balance between these two competing policies. The creation of this safe harbor is not intended to limit the Secretary's regulatory authority to identify other situations in which prepayments do not give rise to investment type property.

Explanation of Provision

In general

The provision creates a safe harbor exception to the general rule that tax-exempt bond-financed prepayments violate the arbitrage restrictions. The term "investment type property" does not include a prepayment under a qualified natural gas supply contract. The provision also provides that such prepayments are not treated as private loans for purposes of the private business tests.

Under the provision, a prepayment financed with tax-exempt bond proceeds for the purpose of obtaining a supply of natural gas for service area customers of a governmental utility is not treated as the acquisition of investment-type property. A contract is a qualified natural gas supply contract if the volume of natural gas secured for any year covered by the prepayment does not exceed the sum of (1) the average annual natural gas purchased (other than for resale) by customers of the utility within the service area of the utility ("retail natural gas consumption") during the testing period, and (2) the amount of natural gas that is needed to fuel transportation of the natural gas to the governmental utility. The testing period is the 5-calendar-year period immediately preceding the calendar year in which the bonds are issued. A retail customer is one who does not purchase natural gas for resale. Natural gas used to generate electricity by a governmental utility is counted as retail natural gas consumption if the electricity was sold to retail customers within the service area of the governmental electric utility.

With respect to qualified natural gas supply contracts entered into by joint action agencies acting for or on behalf of one or more governmental utilities, the requirements of the safe harbor are tested at the utility level. A joint action agency shall be treated as the agent of the utility when selling directly to a retail customer within that utility's service area.

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[55] Internal Revenue Service, *Clarification of Proposed Regulations Relating to Tax-Exempt Bonds Issued by State or Local Governments*, Notice 2002-52, 2002-30 IRB 1 (July 03, 2002).

Adjustments

The volume of gas permitted by the general rule is reduced by natural gas otherwise available on the date of issuance. Specifically, the amount of natural gas permitted to be acquired under a qualified natural gas supply contract for any period is to be reduced by the applicable share of natural gas held by the utility on the date of issuance of the bonds and natural gas that the utility has a right to acquire for the prepayment period (determined as of the date of issuance).[56] For purposes of the preceding sentence, applicable share means, with respect to any period, the natural gas allocable to such period if the gas were allocated ratably over the period to which the prepayment relates.

For purposes of the safe harbor, if after the close of the testing period and before the issue date of the bonds (1) the governmental utility enters into a contract to supply natural gas (other than for resale) for use by a business at a property within the service area of such utility and (2) the gas consumption for such property was not included in the testing period or the ratable amount of natural gas to be supplied under the contract is significantly greater than the ratable amount of gas supplied to such property during the testing period, then the amount of gas permitted to be purchased may be increased to accommodate the contract.

The average annual retail natural gas consumption calculation for purposes of the safe harbor, however, is not to exceed the annual amount of natural gas reasonably expected to be purchased (other than for resale) by persons who are located within the service area of such utility and who, as of the date of issuance of the issue, are customers of such utility.

Intentional acts

The safe harbor does not apply if the utility engages in intentional acts to render the volume of natural gas covered by the prepayment to be in excess of that needed for (1) retail natural gas consumption, and (2) the amount of natural gas that is needed to fuel transportation of the natural gas to the governmental utility. Sales to dispose of excess gas outside the service area that are necessitated by circumstances beyond the control of the utility, such as weather conditions, are not considered intentional acts to render the prepaid gas supply in excess of the utility's needs.

Definition of service area

Service area is defined as (1) any area throughout which the governmental utility provided (at all times during the testing period) in the case of a natural gas utility, natural gas transmission or distribution service, or in the case of an electric utility, electric distribution service; (2) limited areas contiguous to such areas, and (3) any area recognized as the service area of the governmental utility under State or Federal law. Contiguous areas are limited to any

[56] For example, natural gas otherwise available on the date the bonds are issued includes supply covered by other prepayment contracts for the period, and supply held in storage or subject to an option to purchase by such utility that is available for retail natural gas consumption during the period covered by the prepayment. It does not include supply that could be purchased on the open market during the prepayment period.

area within a county contiguous to the area described in (1) in which retail customers of the utility are located if such area is not also served by another utility providing the same service.

Ruling request for higher prepayment amounts

Upon written request, the Secretary may allow an issuer to prepay for an amount of gas greater than that allowed by the safe harbor based on objective evidence of growth in gas consumption or population that demonstrates that the amount permitted by the exception is insufficient.

Effective Date

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

TITLE VI – ELECTRIC UTILITY RESTRUCTURING PROVISIONS

A. Modifications to Special Rules for Nuclear Decommissioning Costs (sec. 601 of the bill and sec. 468A of the Code)

Present Law

Overview

Special rules dealing with nuclear decommissioning reserve funds were adopted by Congress in the Deficit Reduction Act of 1984 ("1984 Act"), when tax issues regarding the time value of money were addressed generally. Under general tax accounting rules, a deduction for accrual basis taxpayers is deferred until there is economic performance for the item for which the deduction is claimed. However, the 1984 Act contains an exception under which a taxpayer responsible for nuclear powerplant decommissioning may elect to deduct contributions made to a qualified nuclear decommissioning fund for future decommissioning costs. Taxpayers who do not elect this provision are subject to general tax accounting rules.

Qualified nuclear decommissioning fund

A qualified nuclear decommissioning fund (a "qualified fund") is a segregated fund established by a taxpayer that is used exclusively for the payment of decommissioning costs, taxes on fund income, management costs of the fund, and for making investments. The income of the fund is taxed at a reduced rate of 20 percent for taxable years beginning after December 31, 1995.[57]

Contributions to a qualified fund are deductible in the year made to the extent that these amounts were collected as part of the cost of service to ratepayers (the "cost of service requirement").[58] Funds withdrawn by the taxpayer to pay for decommissioning costs are included in the taxpayer's income, but the taxpayer also is entitled to a deduction for decommissioning costs as economic performance for such costs occurs.

Accumulations in a qualified fund are limited to the amount required to fund decommissioning costs of a nuclear powerplant for the period during which the qualified fund is in existence (generally post-1984 decommissioning costs of a nuclear powerplant). For this purpose, decommissioning costs are considered to accrue ratably over a nuclear powerplant's

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[57] As originally enacted in 1984, a qualified fund paid tax on its earnings at the top corporate rate and, as a result, there was no present-value tax benefit of making deductible contributions to a qualified fund. Also, as originally enacted, the funds in the trust could be invested only in certain low risk investments. Subsequent amendments to the provision have reduced the rate of tax on a qualified fund to 20 percent and removed the restrictions on the types of permitted investments that a qualified fund can make.

[58] Taxpayers are required to include in gross income customer charges for decommissioning costs (sec. 88).

estimated useful life. In order to prevent accumulations of funds over the remaining life of a nuclear powerplant in excess of those required to pay future decommissioning costs of such nuclear powerplant and to ensure that contributions to a qualified fund are not deducted more rapidly than level funding (taking into account an appropriate discount rate), taxpayers must obtain a ruling from the IRS to establish the maximum annual contribution that may be made to a qualified fund (the "ruling amount"). In certain instances (e.g., change in estimates), a taxpayer is required to obtain a new ruling amount to reflect updated information.

A qualified fund may be transferred in connection with the sale, exchange or other transfer of the nuclear powerplant to which it relates. If the transferee is a regulated public utility and meets certain other requirements, the transfer will be treated as a nontaxable transaction. No gain or loss will be recognized on the transfer of the qualified fund and the transferee will take the transferor's basis in the fund.[59] The transferee is required to obtain a new ruling amount from the IRS or accept a discretionary determination by the IRS.[60]

Nonqualified nuclear decommissioning funds

Federal and State regulators may require utilities to set aside funds for nuclear decommissioning costs in excess of the amount allowed as a deductible contribution to a qualified fund. In addition, taxpayers may have set aside funds prior to the effective date of the qualified fund rules.[61] The treatment of amounts set aside for decommissioning costs prior to 1984 varies. Some taxpayers may have received no tax benefit while others may have deducted such amounts or excluded such amounts from income. Since 1984, taxpayers have been required to include in gross income customer charges for decommissioning costs (sec. 88), and a deduction has not been allowed for amounts set aside to pay for decommissioning costs except through the use of a qualified fund. Income earned in a nonqualified fund is taxable to the fund's owner as it is earned.

Reasons for Change

The Committee does not believe a utility should be denied the opportunity to contribute to a qualified fund simply because it operates in a deregulated environment. The Committee also believes that it is appropriate to permit all decommissioning costs associated with a nuclear powerplant to be funded through a qualified fund. In addition, the Committee recognizes the importance of providing clear and concise rules to minimize disputes between taxpayers and the IRS.

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[59] Treas. reg. sec. 1.468A-6.

[60] Treas. reg. sec. 1.468A-6(f).

[61] These funds are generally referred to as "nonqualified funds."

Explanation of Provision

Repeal of cost of service requirement

The provision repeals the cost of service requirement for deductible contributions to a nuclear decommissioning fund. Thus, all taxpayers, including unregulated taxpayers, would be allowed a deduction for amounts contributed to a qualified fund.

Permit contributions to a qualified fund for pre-1984 decommissioning costs

The proposal also repeals the limitation that a qualified fund only accumulate an amount sufficient to pay for a nuclear powerplant's decommissioning costs incurred during the period that the qualified fund is in existence (generally post-1984 decommissioning costs). Thus, any taxpayer is permitted to accumulate an amount sufficient to cover the present value of 100 percent of a nuclear powerplant's estimated decommissioning costs in a qualified fund. The proposal does not change the requirement that contributions to a qualified fund not be deducted more rapidly than level funding.

Clarify treatment of transfers of qualified funds

The provision clarifies the Federal income tax treatment of the transfer of a qualified fund. No gain or loss would be recognized to the transferor or the transferee (or the qualified fund) as a result of the transfer of a qualified fund in connection with the transfer of the power plant with respect to which such fund was established.

Exception to ruling amount for certain decommissioning costs

The provision permits a taxpayer to make contributions to a qualified fund in excess of the ruling amount in one circumstance. Specifically, a taxpayer is permitted to contribute up to the present value of the amount required to fund a nuclear powerplant's decommissioning costs which under present law section 468A(d)(2)(A) is not permitted to be accumulated in a qualified fund (generally pre-1984 decommissioning costs).[62] It is anticipated that an amount that is permitted to be contributed under this special rule shall be determined using the estimate of total decommissioning costs used for purposes of determining the taxpayer's most recent ruling amount. Any amount transferred to the qualified fund under this special rule that has not previously been deducted, or excluded from gross income is allowed as a deduction over the remaining useful life of the nuclear powerplant.[63] If a qualified fund that has received amounts

[62] The ability to transfer property into a qualified fund under this special rule is available only to the extent the taxpayer has not obtained a new ruling amount incorporating the repeal of the limitation that a qualified fund only accumulate an amount sufficient to pay for decommissioning costs of a nuclear powerplant incurred during the period that the fund is in existence (generally post 1984 decommissioning costs).

[63] A taxpayer recognizes no gain or loss on the contribution of property to a qualified fund under this special rule. The qualified fund will take a transferred (carryover) basis in such

under this rule is transferred to another person, that person will be entitled to the deduction at the same time and in the same manner as the transferor. Thus, if the transferor was not subject to tax at the time and thus would have been unable to use the deduction, the transferee will similarly not be able to utilize the deduction.

Effective Date

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

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property. Correspondingly, a taxpayer's deduction (over the estimated life of the nuclear powerplant) is to be based on the adjusted tax basis of the property contributed rather than the fair market value of such property.

B. Treatment of Certain Income of Cooperatives (sec. 602 of the bill and sec. 501 of the Code)

Present Law

In general

Under present law, an entity must be operated on a cooperative basis in order to be treated as a cooperative for Federal income tax purposes. Although not defined by statute or regulation, the two principal criteria for determining whether an entity is operating on a cooperative basis are: (1) ownership of the cooperative by persons who patronize the cooperative; and (2) return of earnings to patrons in proportion to their patronage. The IRS requires that cooperatives must operate under the following principles: (1) subordination of capital in control over the cooperative undertaking and in ownership of the financial benefits from the cooperative; (2) democratic control by the members of the cooperative; (3) vesting in and allocation among the members of all excess of operating revenues over the expenses incurred to generate revenues in proportion to their participation in the cooperative (patronage); and (4) operation at cost (not operating for profit or below cost).[64]

In general, cooperative members are those who participate in the management of the cooperative and who share in patronage capital. As described below, income from the sale of electric energy by an electric cooperative may be member or non-member income to the cooperative, depending on the membership status of the purchaser. A municipal corporation may be a member of a cooperative.

For Federal income tax purposes, a cooperative generally computes its income as if it were a taxable corporation, with one exception--the cooperative may exclude from its taxable income distributions of patronage dividends. In general, patronage dividends are the profits of the cooperative that are rebated to its patrons pursuant to a pre-existing obligation of the cooperative to do so. The rebate must be made in some equitable fashion on the basis of the quantity or value of business done with the cooperative.

Except for tax-exempt farmers' cooperatives, cooperatives that are subject to the cooperative tax rules of subchapter T of the Code (sec. 1381, *et seq.*) are permitted a deduction for patronage dividends from their taxable income only to the extent of net income that is derived from transactions with patrons who are members of the cooperative (sec. 1382). The availability of such deductions from taxable income has the effect of allowing the cooperative to be treated like a conduit with respect to profits derived from transactions with patrons who are members of the cooperative.

Cooperatives that qualify as tax-exempt farmers' cooperatives are permitted to exclude patronage dividends from their taxable income to the extent of all net income, including net income that is derived from transactions with patrons who are not members of the cooperative,

[64] Announcement 96-24, Proposed Examination Guidelines Regarding Rural Electric Cooperatives, 1996-16 I.R.B. 35.

provided the value of transactions with patrons who are not members of the cooperative does not exceed the value of transactions with patrons who are members of the cooperative (sec. 521).

Taxation of electric cooperatives exempt from subchapter T

In general, the cooperative tax rules of subchapter T apply to any corporation operating on a cooperative basis (except mutual savings banks, insurance companies, other tax-exempt organizations, and certain utilities), including tax-exempt farmers' cooperatives (described in sec. 521(b)). However, subchapter T does not apply to an organization that is "engaged in furnishing electric energy, or providing telephone service, to persons in rural areas" (sec. 1381(a)(2)(C)). Instead, electric cooperatives are taxed under rules that were generally applicable to cooperatives prior to the enactment of subchapter T in 1962. Under these rules, an electric cooperative can exclude patronage dividends from taxable income to the extent of all net income of the cooperative, including net income derived from transactions with patrons who are not members of the cooperative.[65]

Tax exemption of rural electric cooperatives

Section 501(c)(12) provides an income tax exemption for rural electric cooperatives if at least 85 percent of the cooperative's income consists of amounts collected from members for the sole purpose of meeting losses and expenses of providing service to its members. The IRS takes the position that rural electric cooperatives also must comply with the fundamental cooperative principles described above in order to qualify for tax exemption under section 501(c)(12).[66] The 85-percent test is determined without taking into account any income from qualified pole rentals and cancellation of indebtedness income from the prepayment of a loan under sections 306A, 306B, or 311 of the Rural Electrification Act of 1936 (as in effect on January 1, 1987). The exclusion for cancellation of indebtedness income applies to such income arising in 1987, 1988, or 1989 on debt that either originated with, or is guaranteed by, the Federal Government. Rural electric cooperatives generally are subject to the tax on unrelated trade or business income under section 511.

Reasons for Change

The purpose of the 85-percent test under section 501(c)(12) is to ensure that the primary activities of a tax-exempt electric cooperative fulfill the statutory purpose of providing electricity services to the members of the cooperative. Similarly, the fundamental cooperative principles described above are the defining characteristics of a cooperative upon which the Federal tax rules condition conduit treatment.

The Committee believes that the nature of an electric cooperative's activities does not change because it has income from open access transactions with non-members or from nuclear decommissioning transactions (as these terms are defined in the bill). Accordingly, the Committee believes that the 85-percent test for tax exemption under present law should be

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[65] *See* Rev. Rul. 83-135, 1983-2 C.B. 149.

[66] Rev. Rul. 72-36, 1972-1 C.B. 151.

applied without regard to such income. The Committee intends that the term "open access transaction" shall be applied in a manner that allows an electric cooperative to carry out its statutory purpose in a restructured electric energy market environment without adversely impacting its tax-exempt status.

For similar reasons, the Committee believes that the 85-percent test for tax exemption under present law should be applied without regard to cancellation of indebtedness income from the prepayment of certain loans that are provided, insured, or guaranteed by the Federal government, as well as income from certain transactions that would otherwise qualify for deferred gain recognition under section 1031 or 1033.

The Committee further believes that electric energy sales to non-members should not result in a loss of tax-exempt status or cooperative status to the extent that such sales are necessary to replace lost sales of electric energy to members as a result of restructuring of the electric energy industry. Accordingly, the Committee believes that replacement electric energy sales to non-members (defined as "load loss transactions" in the bill) should be treated, for a limited period of time, as member income in applying the 85-percent test for tax exemption of rural electric cooperatives. The Committee believes that such treatment also should apply for purposes of determining whether tax-exempt and taxable electric cooperatives comply with the fundamental cooperative principles. Finally, the Committee believes that income from replacement electric energy sales should not be subject to the tax on unrelated trade or business income under Code section 511.

Explanation of Provision

Treatment of income from open access transactions

The bill provides that income received or accrued by a rural electric cooperative from any "open access transaction" (other than income received or accrued directly or indirectly from a member of the cooperative) is excluded in determining whether a rural electric cooperative satisfies the 85-percent test for tax exemption under section 501(c)(12). The term "open access transaction" is defined as--

(1) the provision or sale of electric energy transmission services or ancillary services on a nondiscriminatory open access basis: (i) pursuant to an open access transmission tariff filed with and approved by the Federal Energy Regulatory Commission ("FERC") (including acceptable reciprocity tariffs), but only if (in the case of a voluntarily filed tariff) the cooperative files a report with FERC within 90 days of enactment of this provision relating to whether or not the cooperative will join a regional transmission organization ("RTO"); or (ii) under an RTO agreement approved by FERC (including an agreement providing for the transfer of control--but not ownership--of transmission facilities);[67]

[67] Under this provision, references to FERC are treated as including references to the Public Utility Commission of Texas or the Rural Utilities Service.

(2) the provision or sale of electric energy distribution services or ancillary services on a nondiscriminatory open access basis to end-users served by distribution facilities owned by the cooperative or its members; or

(3) the delivery or sale of electric energy on a nondiscriminatory open access basis, provided that such electric energy is generated by a generation facility that is directly connected to distribution facilities owned by the cooperative (or its members) which owns the generation facility.

For purposes of the 85-percent test, the bill also provides that income received or accrued by a rural electric cooperative from any "open access transaction" is treated as an amount collected from members for the sole purpose of meeting losses and expenses if the income is received or accrued indirectly from a member of the cooperative.

Treatment of income from nuclear decommissioning transactions

The bill provides that income received or accrued by a rural electric cooperative from any "nuclear decommissioning transaction" also is excluded in determining whether a rural electric cooperative satisfies the 85-percent test for tax exemption under section 501(c)(12). The term "nuclear decommissioning transaction" is defined as--

(1) any transfer into a trust, fund, or instrument established to pay any nuclear decommissioning costs if the transfer is in connection with the transfer of the cooperative's interest in a nuclear powerplant or nuclear powerplant unit;

(2) any distribution from a trust, fund, or instrument established to pay any nuclear decommissioning costs; or

(3) any earnings from a trust, fund, or instrument established to pay any nuclear decommissioning costs.

Treatment of income from asset exchange or conversion transactions

The bill provides that gain realized by a tax-exempt rural electric cooperative from a voluntary exchange or involuntary conversion of certain property is excluded in determining whether a rural electric cooperative satisfies the 85-percent test for tax exemption under section 501(c)(12). This provision only applies to the extent that: (1) the gain would qualify for deferred recognition under section 1031 (relating to exchanges of property held for productive use or investment) or section 1033 (relating to involuntary conversions); and (2) the replacement property that is acquired by the cooperative pursuant to section 1031 or section 1033 (as the case may be) constitutes property that is used, or to be used, for the purpose of generating, transmitting, distributing, or selling electricity or methane-based natural gas.

Treatment of cancellation of indebtedness income from prepayment of certain loans

The bill provides that income from the prepayment of any loan, debt, or obligation of a tax-exempt rural electric cooperative that is originated, insured, or guaranteed by the Federal

Government under the Rural Electrification Act of 1936 is excluded in determining whether the cooperative satisfies the 85-percent test for tax exemption under section 501(c)(12).

Treatment of income from load loss transactions

Tax-exempt rural electric cooperatives.–The bill provides that income received or accrued by a tax-exempt rural electric cooperative from a "load loss transaction" is treated under 501(c)(12) as income collected from members for the sole purpose of meeting losses and expenses of providing service to its members. Therefore, income from load loss transactions is treated as member income in determining whether a rural electric cooperative satisfies the 85-percent test for tax exemption under section 501(c)(12). The bill also provides that income from load loss transactions does not cause a tax-exempt electric cooperative to fail to be treated for Federal income tax purposes as a mutual or cooperative company under the fundamental cooperative principles described above.

The term "load loss transaction" is generally defined as any wholesale or retail sale of electric energy (other than to a member of the cooperative) to the extent that the aggregate amount of such sales during a seven-year period beginning with the "start-up year" does not exceed the reduction in the amount of sales of electric energy during such period by the cooperative to members. The "start-up year" is defined as the calendar year which includes the date of enactment of this provision or, if later, at the election of the cooperative: (1) the first year that the cooperative offers nondiscriminatory open access; or (2) the first year in which at least 10 percent of the cooperative's sales of electric energy are to patrons who are not members of the cooperative.

The bill also excludes income received or accrued by rural electric cooperatives from load loss transactions from the tax on unrelated trade or business income.

Taxable electric cooperatives.–The bill provides that the receipt or accrual of income from load loss transactions by taxable electric cooperatives is treated as income from patrons who are members of the cooperative. Thus, income from a load loss transaction is excludible from the taxable income of a taxable electric cooperative if the cooperative distributes such income pursuant to a pre-existing contract to distribute the income to a patron who is not a member of the cooperative. The bill also provides that income from load loss transactions does not cause a taxable electric cooperative to fail to be treated for Federal income tax purposes as a mutual or cooperative company under the fundamental cooperative principles described above.

Effective Date

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

C. Sales or Dispositions to Implement Federal Energy Regulatory Commission or State Electric Restructuring Policy (sec. 603 of the bill and sec. 451 of the Code)

Present Law

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

Reasons for Change

The Committee recognizes that electric deregulation has been occurring, and is continuing to occur, at both the Federal and State level. Federal and state energy regulators are calling for the "unbundling" of electric transmission assets held by vertically integrated utilities, with the transmission assets ultimately placed under the ownership or control of independent transmission providers (or other similarly-approved operators). This policy is intended to improve transmission management and facilitate the formation of competitive markets. To facilitate the implementation of these policy objectives, the Committee believes it is appropriate to assist taxpayers in moving forward with industry restructuring by providing a tax deferral for gain associated with certain dispositions of electric transmission assets.

Explanation of Provision

The provision permits a taxpayer to elect to recognize gain from a qualifying electric transmission transaction ratably over an eight-year period beginning in the year of sale. A qualifying electric transmission transaction is the sale or other disposition of property used by the taxpayer in the trade or business of providing electric transmission services, or an ownership interest in such an entity, to an independent transmission company[68] prior to January 1, 2008.

A taxpayer electing the application of the provision is required to attach a statement to that effect in the tax return for the taxable year in which the transaction takes place in the manner as the Secretary shall prescribe. The election shall be binding for that taxable year and all subsequent taxable years.[69]

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[68] In general, an independent transmission company is defined as: (1) a regional transmission organization approved by the FERC; (2) a person (i) who the FERC determines under section 203 of the Federal Power Act is not a "market participant" and (ii) whose transmission facilities are placed under the operational control of a FERC-approved regional transmission organization before the close of the period specified in such authorization, but not later than January 1, 2008; or (3) in the case of facilities subject to the exclusive jurisdiction of the Public Utility Commission of Texas, a person who is approved by that commission as consistent with Texas state law regarding an independent transmission organization.

[69] The provision also provides that the installment sale rules shall not apply to any qualifying electric transmission transaction that elects the application of this provision.

Effective Date

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

TITLE VII – ADDITIONAL PROVISIONS

A. Extension of Accelerated Depreciation and Wage Credit Benefits on Indian Reservations (sec. 701 of the bill and secs. 45A and 168(j) of the Code)

Present Law

Present law includes the following tax incentives for businesses located within Indian reservations.

Accelerated depreciation

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:

3-year property	2 years
5-year property	3 years
7-year property	4 years
10-year property	6 years
15-year property	9 years
20-year property	12 years
Nonresidential real property	22 years

"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.

Indian employment credit

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 December 31, 2004.

Reasons for Change

The Committee recognizes the significant potential on Indian lands for development of energy resources and other projects. The special nature of Native American tribes and high poverty rates in certain areas in some circumstances create unique barriers to development that these incentives help overcome. The Committee understands that a significant portion of these incentives are used in development of energy projects.

The Committee concluded that extending the accelerated depreciation and wage credit tax incentives within Indian reservations will both increase the supply of energy and expand business and employment opportunities in these areas.

Explanation of Provision

Accelerated depreciation

The provision extends the accelerated depreciation incentive for one year (to property placed in service before January 1, 2006).

Indian employment credit

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.

B. GAO Study
(sec. 702 of the bill)

Present Law

Present law does not require study of the present law provisions relating to clean fuel vehicles and electric vehicles.

Reasons for Change

The Committee believes it is important to gain information on the value of benefits compared to costs in order to make informed decisions regarding the propriety of special tax treatment of various products or technologies designed to reduce dependence on petroleum, reduce emissions of pollutants, or to promote energy conservation. The Committee believes it is important to have measures of the amount of conservation or reduction in pollution that results from provisions designed to achieve such results.

Explanation of Provision

The bill directs the Comptroller General to undertake an ongoing analysis of the effectiveness of the tax credits allowed to alternative motor vehicles and the tax credits allowed to various alternative fuels under Title II of the bill and the tax credits and enhanced deductions allowed for energy conservation and efficiency under Title III of the bill. The studies should estimate the energy savings and reductions in pollutants achieved from taxpayer utilization of these provisions. The studies should estimate the dollar value of the benefits of reduced energy consumption and reduced air pollution in comparison to estimates of the revenue cost of these provisions to the U.S. Treasury. The studies should include an analysis of the distribution of the taxpayers who utilize these provisions by income and other relevant characteristics.

The bill directs the Comptroller General to submit annual reports to Congress beginning not later than December 31, 2004.

Effective Date

The provision is effective on the date of enactment.

C. Repeal Certain Excise Taxes on Rail Diesel Fuel and Inland Waterway Barge Fuels (sec. 703 of the bill and secs. 4041 and 4042 of the Code)

Present Law

Under present law, diesel fuel used in trains is subject to a 4.4-cents-per gallon excise tax. Revenues from 4.3 cents per gallon of this excise tax are retained in the General Fund of the Treasury. The remaining 0.1-cent per gallon is deposited in the Leaking Underground Storage Tank ("LUST") Trust Fund.[70]

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

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

Reasons for Change

The Committee notes that in 1993, the Congress enacted the present-law 4.3-cents-per-gallon excise tax on motor fuels as a deficit reduction measure, with the receipts payable to the General Fund. Since that time, the Congress has diverted the 4.3-cents-per-gallon excise tax for most uses to specified trust funds that provide benefits for those motor fuel users who ultimately bear the burden of these taxes. As a result, the Committee finds that generally only rail and barge operators remain as motor fuel users subject to the 4.3-cents-per-gallon excise tax who receive no benefits from a dedicated trust fund as a result of their tax burden. The Committee observes that rail and barge operators compete with other transportation service providers who benefit from expenditures paid from dedicated trust funds. The Committee concludes that it is inequitable and distortive of transportation decisions to continue to impose the 4.3-cents-per-gallon excise tax on diesel fuel used in trains and barges.

Explanation of Provision

The 4.3-cents-per-gallon General Fund excise tax rate on diesel fuel used in trains and fuels used in barges operating on the designated inland waterways system is repealed. The 0.1 cent per gallon for the Leaking Underground Storage Tank ("LUST") Trust Fund is unchanged by the provision.

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[70] The 0.1cent per gallon for the LUST Trust Fund applies so long as there is a tax imposed on rail diesel and the LUST Trust Fund tax is in effect (secs. 4041(d)(1) and (3), and 4081(d)(3)).

Effective Date

The proposal is effective on January 1, 2004.

D. Modify Research Credit for Research Relating to Energy (sec. 704 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 applied to the excess of (1) 100 percent of corporate cash expenses (including grants or contributions) 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)).

Alternative incremental research credit regime

Taxpayers are allowed to elect an alternative incremental research credit regime.[71] 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.

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

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[71] Sec. 41(c)(4).

incurred by the taxpayer to certain other persons for qualified research conducted on the taxpayer's behalf (so-called contract research expenses). In the case of amounts paid to a research consortium, 75 percent of amounts paid for qualified research is treated as qualified research expenses eligible for the research credit (rather than 65 percent under the general rule) 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.

To be eligible for the credit, the research must not only satisfy the requirements of present-law section 174 for the deduction for research expenses, 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.

Reasons for Change

The Committee believes that research into energy production and energy conservation will help reduce pollution and enhance energy independence in the future.

Explanation of Provision

The bill modifies the present-law research credit as it applies to qualified energy research. In particular, the provision provides that the taxpayer may claim a credit equal to 20 percent of the taxpayer's expenditures on qualified energy research undertaken by an energy research consortium.[72] The amount of credit claimed is determined only by regard to such expenditures by the taxpayer within the taxable year. Unlike the general rule for the research credit, the 20-percent credit for research by an energy research consortium applies to all such expenditures, not only those in excess of a base amount however determined. An energy research consortium is a qualified research consortium as under present law that also is organized and operated primarily to conduct energy research and development in the public interest and to which at least five unrelated persons paid, or incurred amounts, to such organization within the calendar year. In addition, to be a qualified energy research consortium no single person shall pay or incur more than 50 percent of the total amounts received by the research consortium during the calendar year.

The bill also provides that 100 percent of amounts paid or incurred by the taxpayer to eligible small businesses, universities, and Federal for qualified energy research would constitute qualified research expenses as contract research expenses, rather than 65 percent of qualified research expenditures allowed under present law. An eligible small business for this purpose is a

[72] Allowable expenditures for the purpose of the credit include contributions to an energy research consortium.

business in which the taxpayer does not own a 50 percent or greater interest and the business has employed, on average, 500 or fewer employees in the two preceding calendar years.

Qualified energy research expenditures are expenditures that would otherwise qualify for the research credit under present law and relate to the production, supply, and conservation of energy, including otherwise qualifying research expenditures related to alternative energy sources or the use of alternative energy sources. For example, research relating to hydrogen fuel cell vehicles would qualify under this provision, if the research expenditures otherwise satisfy the criteria of present-law sec. 41. Likewise, otherwise qualifying research undertaken to improve the energy-efficiency of lighting would qualify under this provision.

Effective Date

The provision is effective for amounts paid or incurred after the date of enactment in taxable years ending after such date.

TITLE VIII – REVENUE PROVISIONS

A. Provisions Designed to Curtail Tax Shelters

1. Penalty for failure to disclose reportable transactions (sec. 801 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.[73]

There are six categories of reportable transactions. The first category is any transaction that is the same as (or substantially similar to)[74] 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").[75]

The second category is any transaction that is offered under conditions of confidentiality. In general, if a taxpayer's disclosure of the structure or tax aspects of the transaction is limited in any way by an express or implied understanding or agreement with or for the benefit of any person who makes or provides a statement, oral or written, as to the potential tax consequences that may result from the transaction, it is considered offered under conditions of confidentiality (whether or not the understanding is legally binding).[76]

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

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[73] 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.

[74] 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).

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

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

transaction are not sustained or, (2) the fees are contingent on the intended tax consequences from the transaction being sustained.[77]

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.[78]

The fifth category of reportable transactions refers to any transaction done by certain taxpayers[79] in which the tax treatment of the transaction differs (or is expected to differ) by more than $10 million from its treatment for book purposes (using generally accepted accounting principles) in any year.[80]

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.[81]

Under present law, there is no specific penalty for failing to disclose a reportable transaction; however, such a failure may jeopardize a taxpayer's ability to claim that any income tax understatement attributable to such undisclosed transaction is due to reasonable cause, and that the taxpayer acted in good faith.[82]

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

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

[79] 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.

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

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

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

Reasons for Change

The Committee is aware that individuals and corporations are increasingly using sophisticated transactions to avoid or evade Federal income tax.[83] Such a phenomenon could pose a serious threat to the efficacy of the tax system because of both the potential loss of revenue and the potential threat to the integrity and perceived fairness of the self-assessment system.

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

Explanation of Provision

In general

The bill 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 bill does not define the terms "listed transaction"[84] or "reportable transaction," nor does the bill explain the type of information that must be disclosed in order to avoid the

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

[84] 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.

imposition of a penalty. Rather, the bill authorizes the Treasury Department to define a "listed transaction" and a "reportable transaction" under section 6011.

Penalty rate

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

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

A public entity that is required to pay a penalty for failing to disclose a listed transaction (or is subject to an understatement penalty attributable to a non-disclosed listed transaction or a non-disclosed reportable avoidance transaction[85]) must disclose the imposition of the penalty in reports to the Securities and Exchange Commission for such period as the Secretary shall specify. The bill applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear, and treats any failure to disclose a transaction in such reports as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the Securities and Exchange Commission once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).

Effective Date

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

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

2. Modifications to the accuracy-related penalties for listed transactions and reportable transactions having a significant tax avoidance purpose (sec. 802 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.[86] The amount of any understatement generally is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.[87]

Special rules apply with respect to tax shelters.[88] 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.[89] 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.[90]

Reasons for Change

Because the Treasury shelter initiative emphasizes combating abusive tax avoidance transactions by requiring increased disclosure of such transactions by all parties involved, the Committee believes that taxpayers should be subject to a strict liability penalty on an

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[86] Sec. 6662.

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

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

[89] Sec. 6664(c).

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

understatement of tax that is attributable to non-disclosed listed transactions or non-disclosed reportable transactions that have a significant purpose of tax avoidance. Furthermore, in order to deter taxpayers from entering into tax avoidance transactions, the Committee believes that a more meaningful (but less stringent) accuracy-related penalty should apply to such transactions even when disclosed.

Explanation of Provision

In general

The bill 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").[91] The penalty rate and defenses available to avoid the penalty vary depending on whether the transaction was adequately disclosed.

Disclosed transactions

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

Undisclosed transactions

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

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

Once the 30 percent penalty has been included in the Revenue Agent Report, the penalty cannot be compromised for purposes of a settlement without approval of the Commissioner personally or the head of the Office of Tax Shelter Analysis. Furthermore, the IRS is required to

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

submit an annual report to Congress summarizing the application of this penalty and providing a description of each penalty compromised under this provision and the reasons for the compromise.

Determination of the understatement amount

The penalty is applied to the amount of any understatement attributable to the listed or reportable avoidance transaction without regard to other items on the tax return. For purposes of this bill, 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) [92], 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 bill 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,[93] (2) that there is or was substantial authority for such treatment, and (3) that the taxpayer reasonably believed that such treatment was more likely than not the proper treatment. For this purpose, a taxpayer will be treated as having a reasonable belief with respect to the tax treatment of an item only if such belief (1) is based on the facts and law that exist at the time the tax return (that includes the item) is filed, and (2) relates solely to the taxpayer's chances of success on the merits and does not take into account the possibility that (a) a return will not be audited, (b) the treatment will not be raised on audit, or (c) the treatment will be resolved through settlement if raised.

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

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[92] 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.

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

Disqualified tax advisor

A disqualified tax advisor is any advisor who (1) is a material advisor[94] and who participates in the organization, management, promotion or sale of the transaction or is related (within the meaning of section 267 or 707) to any person who so participates, (2) is compensated directly or indirectly[95] 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 continuing 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.[96] 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.

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

[95] 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.

[96] 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).

Disqualified opinion

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

Coordination with other penalties

Any understatement upon which a penalty is imposed under this bill 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 bill is effective for taxable years ending after the date of enactment.

3. Tax shelter exception to confidentiality privileges relating to taxpayer communications (sec. 803 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 bill 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 bill is effective with respect to communications made on or after the date of enactment.

4. Disclosure of reportable transactions by material advisors (secs. 804 and 805 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.[97] A "tax shelter" means any investment with respect to which the tax shelter ratio[98] 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 at least five investors).[99]

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.[100]

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,"[101] 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

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[97] Sec. 6111(a).

[98] 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.

[99] Sec. 6111(c).

[100] Sec. 6111(d).

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

one taxpayer.[102] Certain exceptions are provided with respect to the second category of transactions.[103]

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.[104]

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.[105] However, if the tax shelter involves an arrangement offered to a corporation under conditions of confidentiality, the penalty is the greater of $10,000 or 50 percent of the fees payable to any promoter with respect to offerings prior to the date of late registration. Intentional disregard of the requirement to register increases the penalty to 75 percent of the applicable fees.

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

Reasons for Change

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

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

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

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

[104] 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).

[105] Sec. 6707.

Explanation of Provision

Disclosure of reportable transactions by material advisors

The bill repeals the present law rules with respect to registration of tax shelters. Instead, the bill requires each material advisor with respect to any reportable transaction (including any listed transaction)[106] 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.[107]

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

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

Penalty for failing to furnish information regarding reportable transactions

The bill repeals the present law penalty for failure to register tax shelters. Instead, the bill 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).[108] 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

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

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

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

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

<u>Effective Date</u>

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.

5. Investor lists and modification of penalty for failure to maintain investor lists (secs. 804 and 806 of the bill and secs. 6112 and 6708 of the Code)

<u>Present Law</u>

<u>Investor lists</u>

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).[110] Recently issued regulations under section 6112 contain rules

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[109] 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.

[110] Sec. 6112.

regarding the list maintenance requirements.[111] In general, the regulations apply to transactions that are potentially abusive tax shelters entered into, or acquired after, February 28, 2003.[112]

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.[113] A material advisor is defined any person who is required to register the transaction under section 6111, or expects to receive a minimum fee of (1) $250,000 for a transaction that is a potentially abusive tax shelter if all participants are corporations, or (2) $50,000 for any other transaction that is a potentially abusive tax shelter.[114] 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).[115]

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.[116]

Penalties for failing to maintain investor lists

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

Reasons for Change

The Committee has been advised that the present-law penalties for failure to maintain customer lists are not meaningful and that promoters often have refused to provide requested information to the IRS. The Committee believes that requiring material advisors to maintain a list of advisees with respect to each reportable transaction, coupled with more meaningful

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

[112] 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.

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

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

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

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

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[117] with respect to a reportable transaction (including a listed transaction)[118] 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 bill authorizes (but does not require) the Secretary to prescribe regulations which provide that, in cases in which 2 or more persons are required to maintain the same list, only one person would be required to maintain the list.

Penalty for failing to maintain investor lists

The bill 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.[119]

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.

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

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

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

6. Penalties on promoters of tax shelters (sec. 807 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.[120] A qualified false or fraudulent statement is any statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter. A "gross valuation overstatement" means any statement as to the value of any property or services if the stated value exceeds 200 percent of the correct valuation, and the value is directly related to the amount of any allowable income tax deduction or credit.

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

Reasons for Change

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

Explanation of Provision

The bill 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 bill is effective for activities after the date of enactment.

[120] Sec. 6700.

B. Provisions to Discourage Corporate Expatriation

1. Tax treatment of inversion transactions (sec. 821 of the bill and new sec. 7874 of the Code)

Present Law

Determination of corporate residence

The U.S. tax treatment of a multinational corporate group depends significantly on whether the top-tier "parent" corporation of the group is domestic or foreign. For purposes of U.S. tax law, a corporation is treated as domestic if it is incorporated under the law of the United States or of any State. All other corporations (i.e., those incorporated under the laws of foreign countries) are treated as foreign. Thus, place of incorporation determines whether a corporation is treated as domestic or foreign for purposes of U.S. tax law, irrespective of other factors that might be thought to bear on a corporation's "nationality," such as the location of the corporation's management activities, employees, business assets, operations, or revenue sources, the exchanges on which the corporation's stock is traded, or the residence of the corporation's managers and shareholders.

U.S. taxation of domestic corporations

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

Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income is generally deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F[121] and the passive foreign investment company rules.[122] 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

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[121] Secs. 951-964.

[122] Secs. 1291-1298.

that is "effectively connected" with the conduct of a trade or business in the United States. Such "effectively connected income" generally is taxed in the same manner and at the same rates as the income of a U.S. corporation. An applicable tax treaty may limit the imposition of U.S. tax on business operations of a foreign corporation to cases in which the business is conducted through a "permanent establishment" in the United States.

In addition, foreign corporations generally are subject to a gross-basis U.S. tax at a flat 30-percent rate on the receipt of interest, dividends, rents, royalties, and certain similar types of income derived from U.S. sources, subject to certain exceptions. The tax generally is collected by means of withholding by the person making the payment. This tax may be reduced or eliminated under an applicable tax treaty.

U.S. tax treatment of inversion transactions

Under present law, U.S. corporations may reincorporate in foreign jurisdictions and thereby replace the U.S. parent corporation of a multinational corporate group with a foreign parent corporation. These transactions are commonly referred to as "inversion" transactions. Inversion transactions may take many different forms, including stock inversions, asset inversions, and various combinations of and variations on the two. Most of the known transactions to date have been stock inversions. In one example of a stock inversion, a U.S. corporation forms a foreign corporation, which in turn forms a domestic merger subsidiary. The domestic merger subsidiary then merges into the U.S. corporation, with the U.S. corporation surviving, now as a subsidiary of the new foreign corporation. The U.S. corporation's shareholders receive shares of the foreign corporation and are treated as having exchanged their U.S. corporation shares for the foreign corporation shares. An asset inversion reaches a similar result, but through a direct merger of the top-tier U.S. corporation into a new foreign corporation, among other possible forms. An inversion transaction may be accompanied or followed by further restructuring of the corporate group. For example, in the case of a stock inversion, in order to remove income from foreign operations from the U.S. taxing jurisdiction, the U.S. corporation may transfer some or all of its foreign subsidiaries directly to the new foreign parent corporation or other related foreign corporations.

In addition to removing foreign operations from the U.S. taxing jurisdiction, the corporate group may derive further advantage from the inverted structure by reducing U.S. tax on U.S.-source income through various "earnings stripping" or other transactions. This may include earnings stripping through payment by a U.S. corporation of deductible amounts such as interest, royalties, rents, or management service fees to the new foreign parent or other foreign affiliates. In this respect, the post-inversion structure enables the group to employ the same tax-reduction strategies that are available to other multinational corporate groups with foreign parents and U.S. subsidiaries, subject to the same limitations. These limitations under present law include section 163(j), which limits the deductibility of certain interest paid to related parties, if the payor's debt-equity ratio exceeds 1.5 to 1 and the payor's net interest expense exceeds 50 percent of its "adjusted taxable income." More generally, section 482 and the regulations thereunder require that all transactions between related parties be conducted on terms consistent with an "arm's length" standard, and permit the Secretary of the Treasury to reallocate income and deductions among such parties if that standard is not met.

Inversion transactions may give rise to immediate U.S. tax consequences at the shareholder and/or the corporate level, depending on the type of inversion. In stock inversions, the U.S. shareholders generally recognize gain (but not loss) under section 367(a), based on the difference between the fair market value of the foreign corporation shares received and the adjusted basis of the domestic corporation stock exchanged. To the extent that a corporation's share value has declined, and/or it has many foreign or tax-exempt shareholders, the impact of this section 367(a) "toll charge" is reduced. The transfer of foreign subsidiaries or other assets to the foreign parent corporation also may give rise to U.S. tax consequences at the corporate level (e.g., gain recognition and earnings and profits inclusions under sections 1001, 311(b), 304, 367, 1248 or other provisions). The tax on any income recognized as a result of these restructurings may be reduced or eliminated through the use of net operating losses, foreign tax credits, and other tax attributes.

In asset inversions, the U.S. corporation generally recognizes gain (but not loss) under section 367(a) as though it had sold all of its assets, but the shareholders generally do not recognize gain or loss, assuming the transaction meets the requirements of a reorganization under section 368.

Reasons for Change

The Committee believes that inversion transactions resulting in a minimal presence in a foreign country of incorporation are a means of avoiding U.S. tax and should be curtailed. In particular, these transactions permit corporations and other entities to continue to conduct business in the same manner as they did prior to the inversion, but with the result that the inverted entity avoids U.S. tax on foreign operations and may engage in earnings-stripping techniques to avoid U.S. tax on domestic operations. The Committee believes that certain inversion transactions (involving 80 percent or greater identity of stock ownership) have little or no non-tax effect or purpose and should be disregarded for U.S. tax purposes. The Committee believes that other inversion transactions (involving greater than 50 but less than 80 percent identity of stock ownership) may have sufficient non-tax effect and purpose to be respected, but warrant heightened scrutiny and other restrictions to ensure that the U.S. tax base is not eroded through related-party transactions.

Explanation of Provision

In general

The provision defines two different types of corporate inversion transactions and establishes a different set of consequences for each type. Certain partnership transactions also are covered.

Transactions involving at least 80 percent identity of stock ownership

The first type of inversion is a transaction in which, pursuant to a plan or a series of related transactions: (1) a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity;[123] (2) the former shareholders of the U.S. corporation hold (by reason of holding stock in the U.S. corporation) 80 percent or more (by vote or value) of the stock of the foreign-incorporated entity after the transaction; and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50 percent ownership (i.e., the "expanded affiliated group"), does not have substantial business activities in the entity's country of incorporation, compared to the total worldwide business activities of the expanded affiliated group. The provision denies the intended tax benefits of this type of inversion by deeming the top-tier foreign corporation to be a domestic corporation for all purposes of the Code.[124]

Except as otherwise provided in regulations, the provision does not apply to a direct or indirect acquisition of the properties of a U.S. corporation no class of the stock of which was traded on an established securities market at any time within the four-year period preceding the acquisition. In determining whether a transaction would meet the definition of an inversion under the provision, stock held by members of the expanded affiliated group that includes the foreign incorporated entity is disregarded. For example, if the former top-tier U.S. corporation receives stock of the foreign incorporated entity (e.g., so-called "hook" stock), the stock would not be considered in determining whether the transaction meets the definition. Stock sold in a public offering (whether initial or secondary) or private placement related to the transaction also is disregarded for these purposes. Acquisitions with respect to a domestic corporation or partnership are deemed to be "pursuant to a plan" if they occur within the four-year period beginning on the date which is two years before the ownership threshold under the provision is met with respect to such corporation or partnership.

Transfers of properties or liabilities as part of a plan a principal purpose of which is to avoid the purposes of the provision are disregarded. In addition, the Treasury Secretary is granted authority to prevent the avoidance of the purposes of the provision, including avoidance through the use of related persons, pass-through or other noncorporate entities, or other intermediaries, and through transactions designed to qualify or disqualify a person as a related person, a member of an expanded affiliated group, or a publicly traded corporation. Similarly, the Treasury Secretary is granted authority to treat certain non-stock instruments as stock, and certain stock as not stock, where necessary to carry out the purposes of the provision.

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[123] It is expected that the Treasury Secretary will issue regulations applying the term "substantially all" in this context and will not be bound in this regard by interpretations of the term in other contexts under the Code.

[124] Since the top-tier foreign corporation is treated for all purposes of the Code as domestic, the shareholder-level "toll charge" of sec. 367(a) does not apply to these inversion transactions. However, with respect to inversion transactions completed before 2004, regulated investment companies and certain similar entities are allowed to elect to recognize gain as if sec. 367(a) did apply.

Transactions involving greater than 50 percent but less than 80 percent identity of stock ownership

The second type of inversion is a transaction that would meet the definition of an inversion transaction described above, except that the 80-percent ownership threshold is not met. In such a case, if a greater-than-50-percent ownership threshold is met, then a second set of rules applies to the inversion. Under these rules, the inversion transaction is respected (i.e., the foreign corporation is treated as foreign), but: (1) any applicable corporate-level "toll charges" for establishing the inverted structure may not be offset by tax attributes such as net operating losses or foreign tax credits; (2) the IRS is given expanded authority to monitor related-party transactions that may be used to reduce U.S. tax on U.S.-source income going forward; and (3) section 163(j), relating to "earnings stripping" through related-party debt, is strengthened. These measures generally apply for a 10-year period following the inversion transaction. In addition, inverting entities are required to provide information to shareholders or partners and the IRS with respect to the inversion transaction.

With respect to "toll charges," any applicable corporate-level income or gain required to be recognized under sections 304, 311(b), 367, 1001, 1248, or any other provision with respect to the transfer of controlled foreign corporation stock or other assets by a U.S. corporation as part of the inversion transaction or after such transaction to a related foreign person is taxable, without offset by any tax attributes (e.g., net operating losses or foreign tax credits). To the extent provided in regulations, this rule will not apply to certain transfers of inventory and similar transactions conducted in the ordinary course of the taxpayer's business.

In order to enhance IRS monitoring of related-party transactions, the provision establishes a new pre-filing procedure. Under this procedure, the taxpayer will be required annually to submit an application to the IRS for an agreement that all return positions to be taken by the taxpayer with respect to related-party transactions comply with all relevant provisions of the Code, including sections 163(j), 267(a)(3), 482, and 845. The Treasury Secretary is given the authority to specify the form, content, and supporting information required for this application, as well as the timing for its submission.

The IRS will be required to take one of the following three actions within 90 days of receiving a complete application from a taxpayer: (1) conclude an agreement with the taxpayer that the return positions to be taken with respect to related-party transactions comply with all relevant provisions of the Code; (2) advise the taxpayer that the IRS is satisfied that the application was made in good faith and substantially complies with the requirements set forth by the Treasury Secretary for such an application, but that the IRS reserves substantive judgment as to the tax treatment of the relevant transactions pending the normal audit process; or (3) advise the taxpayer that the IRS has concluded that the application was not made in good faith or does not substantially comply with the requirements set forth by the Treasury Secretary.

In the case of a compliance failure described in (3) above (and in cases in which the taxpayer fails to submit an application), the following sanctions will apply for the taxable year for which the application was required: (1) no deductions or additions to basis or cost of goods sold for payments to foreign related parties will be permitted; (2) any transfers or licenses of intangible property to related foreign parties will be disregarded; and (3) any cost-sharing arrangements will not be respected. In such a case, the taxpayer may seek direct review by the U.S. Tax Court of the IRS's determination of compliance failure.

If the IRS fails to act on the taxpayer's application within 90 days of receipt, then the taxpayer will be treated as having submitted in good faith an application that substantially complies with the above-referenced requirements. Thus, the deduction disallowance and other sanctions described above will not apply, but the IRS will be able to examine the transactions at issue under the normal audit process. The IRS is authorized to request that the taxpayer extend this 90-day deadline in cases in which the IRS believes that such an extension might help the parties to reach an agreement.

The "earnings stripping" rules of section 163(j), which deny or defer deductions for certain interest paid to foreign related parties, are strengthened for inverted corporations. With respect to such corporations, the provision eliminates the debt-equity threshold generally applicable under section 163(j) and reduces the 50-percent thresholds for "excess interest expense" and "excess limitation" to 25 percent.

In cases in which a U.S. corporate group acquires subsidiaries or other assets from an unrelated inverted corporate group, the provisions described above generally do not apply to the acquiring U.S. corporate group or its related parties (including the newly acquired subsidiaries or assets) by reason of acquiring the subsidiaries or assets that were connected with the inversion transaction. The Treasury Secretary is given authority to issue regulations appropriate to carry out the purposes of this provision and to prevent its abuse.

Partnership transactions

Under the proposal, both types of inversion transactions include certain partnership transactions. Specifically, both parts of the provision apply to transactions in which a foreign-incorporated entity acquires substantially all of the properties constituting a trade or business of a domestic partnership (whether or not publicly traded), if after the acquisition at least 80 percent (or more than 50 percent but less than 80 percent, as the case may be) of the stock of the entity is held by former partners of the partnership (by reason of holding their partnership interests), and the "substantial business activities" test is not met. For purposes of determining whether these tests are met, all partnerships that are under common control within the meaning of section 482 are treated as one partnership, except as provided otherwise in regulations. In addition, the modified "toll charge" provisions apply at the partner level.

Effective Date

The regime applicable to transactions involving at least 80 percent identity of ownership applies to inversion transactions completed after March 20, 2002. The rules for inversion transactions involving greater-than-50-percent identity of ownership apply to inversion transactions completed after 1996 that meet the 50-percent test and to inversion transactions completed after 1996 that would have met the 80-percent test but for the March 20, 2002 date.

2. Excise tax on stock compensation of insiders of inverted corporations (sec. 822 of the bill and new sec. 5000A and sec. 275(a) of the Code)

Present Law

The income taxation of a nonstatutory[125] 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.[126] Upon exercise of such an option, the excess of the fair market value of the stock purchased over the option price is included in the recipient's gross income as ordinary income in such taxable year.

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

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

Reasons for Change

The Committee believes that certain inversion transactions are a means of avoiding U.S. tax and should be curtailed. The Committee is concerned that, while shareholders are generally required to recognize gain upon stock inversion transactions, executives holding stock options and certain stock-based compensation are not taxed upon such transactions. Since such executives are often instrumental in deciding whether to engage in inversion transactions, the Committee believes that, upon certain inversion transactions, it is appropriate to impose an excise tax on certain executives holding stock options and stock-based compensation.

Explanation of Provision

Under the provision, specified holders of stock options and other stock-based compensation are subject to an excise tax upon certain inversion transactions. The provision

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[125] 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.

[126] 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.

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

A disqualified individual is any individual who, with respect to a corporation, is, at any time during the 12-month period beginning on the date which is six months before the inversion date, subject to the requirements of section 16(a) of the Securities and Exchange Act of 1934 with respect to the corporation, or any member of the corporation's expanded affiliated group,[127] 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)),[128] directors, and 10-percent owners of private and publicly-held corporations.

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

Specified stock compensation subject to the excise tax includes any payment[129] (or right to payment) granted by the inverted corporation (or any member of the corporation's expanded affiliated group) to any person in connection with the performance of services by a disqualified individual for such corporation (or member of the corporation's expanded affiliated group) if the value of the payment or right is based on, or determined by reference to, the value or change in value of stock of such corporation (or any member of the corporation's expanded affiliated group). In determining whether such compensation exists and valuing such compensation, all restrictions, other than non-lapse restrictions, are ignored. Thus, the excise tax applies, and the value subject to the tax is determined, without regard to whether such specified stock compensation is subject to a substantial risk of forfeiture or is exercisable at the time of the inversion transaction. Specified stock compensation includes compensatory stock and restricted stock grants, compensatory stock options, and other forms of stock-based compensation,

[127] 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.

[128] 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.

[129] 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.

including stock appreciation rights, phantom stock, and phantom stock options. Specified stock compensation also includes nonqualified deferred compensation that is treated as though it were invested in stock or stock options of the inverting corporation (or member). For example, the provision applies to a disqualified individual's deferred compensation if company stock is one of the actual or deemed investment options under the nonqualified deferred compensation plan.

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

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

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

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

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

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

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

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

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

Effective Date

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

3. Reinsurance agreements (sec. 823 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.[130] 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.[131] In addition, the provision also permits such allocation, recharacterization, or other adjustments in a case in which one of the parties to a reinsurance agreement is, with respect to any contract covered by the agreement, in effect an agent of another party to the agreement, or a conduit between related persons.

Reasons for Change

The Committee is concerned that reinsurance transactions are being used to allocate income, deductions, or other items inappropriately among U.S. and foreign related persons. The Committee is concerned that foreign related party reinsurance arrangements may be a technique for eroding the U.S. tax base. The Committee believes that the provision of present law permitting the Treasury Secretary to allocate or recharacterize items related to a reinsurance agreement should be applied to prevent misallocation, improper characterization, or to make any other adjustment in the case of such reinsurance transactions between U.S. and foreign related persons (or agents or conduits). The Committee also wishes to clarify that, in applying the authority with respect to reinsurance agreements, the amount, source or character of the items may be allocated, recharacterized or adjusted.

Explanation of Provision

The provision clarifies the rules of section 845, relating to authority for the Treasury Secretary to allocate items among the parties to a reinsurance agreement, recharacterize items, or make any other adjustment, in order to reflect the proper source and character of the items for each party. The proposal authorizes such allocation, recharacterization, or other adjustment, in order to reflect the proper source, character or amount of the item. It is intended that this authority[132] be exercised in a manner similar to the authority under section 482 for the Treasury

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[130] Sec. 845(a).

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

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

Secretary to make adjustments between related parties. It is intended that this authority be applied in situations in which the related persons (or agents or conduits) are engaged in cross-border transactions that require allocation, recharacterization, or other adjustments in order to reflect the proper source, character or amount of the item or items. No inference is intended that present law does not provide this authority with respect to reinsurance agreements.

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

Effective Date

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

C. Extension of IRS User Fees
(sec. 831 of the bill and new sec. 7529 of the Code)

Present Law

The IRS provides written responses to questions of individuals, corporations, and organizations relating to their tax status or the effects of particular transactions for tax purposes. The IRS generally charges a fee for requests for a letter ruling, determination letter, opinion letter, or other similar ruling or determination. Public Law 104-117[133] extended the statutory authorization for these user fees[134] through September 30, 2003.

Reasons for Change

The Committee believes that it is appropriate to provide a further extension of these user fees.

Explanation of Provision

The bill extends the statutory authorization for these user fees through September 30, 2013. The bill also moves the statutory authorization for these fees into the Code.[135]

Effective Date

The provision, including moving the statutory authorization for these fees into the Code and repealing the off-Code statutory authorization for these fees, is effective for requests made after the date of enactment.

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[133] 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).

[134] These user fees were originally enacted in section 10511 of the Revenue Act of 1987 (Pub. Law No. 100-203, December 22, 1987).

[135] The proposal also moves 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).

D. Add Vaccines Against Hepatitis A to the List of Taxable Vaccines (sec. 842 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[136] 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 effected States exceeds 20 million. Several of the effected 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.[137] In the unfortunate event of an injury related to this vaccine, families of injured children are eligible for the no-fault arbitration system established under the Vaccine Injury Compensation Program rather than going to Federal Court to seek compensatory redress.

Explanation of Provision

The bill adds any vaccine against hepatitis A to the list of taxable vaccines. The bill also makes a conforming amendment to the trust fund expenditure purposes.

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[136] sec. 4131

[137] 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.

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.

E. Individual Expatriation to Avoid Tax (sec. 833 of the bill and secs. 877, 2107, 2501, and 6039 of the Code)

Present Law

U.S. citizens and residents generally are subject to U.S income taxation on their worldwide income. The U.S. tax may be reduced or offset by a credit allowed for foreign income taxes paid with respect to foreign source income. Nonresidents who are not U.S. citizens are taxed at a flat rate of 30 percent (or a lower treaty rate) on certain types of passive income derived from U.S. sources, and at regular graduated rates on net profits derived from a U.S. trade or business.

An individual who relinquishes his or her U.S. citizenship or terminates his or her U.S. residency[138] with a principal purpose of avoiding U.S. taxes is subject to an alternative method of income taxation for the 10 taxable years ending after the citizenship relinquishment or residency termination (the "alternative tax regime"). The alternative tax regime modifies the rules generally applicable to the taxation of nonresident noncitizens. For the 10-year period, the individual is subject to tax only on U.S.-source income at the rates applicable to U.S. citizens, rather than the rates applicable to nonresident noncitizens. However, for this purpose, U.S.-source income has a broader scope than it does for normal U.S. Federal tax purposes and includes, for example, gain from the sale of U.S. corporate stock or debt obligations. The alternative tax regime applies only if it results in a higher U.S. tax liability than the liability that would result if the individual were taxed as a nonresident noncitizen.

In addition, the alternative tax regime includes special estate and gift tax rules. Under present law, estates of nonresident noncitizens are subject to U.S. estate tax on U.S.-situated property. For these purposes, stock in a foreign corporation generally is not treated as U.S.-situated property, even if the foreign corporation itself owns U.S.-situated property. However, a special estate tax rule (sec. 2107) applies to former citizens and former long-term residents who are subject to the alternative tax regime. Under this rule, 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, if the former citizen or former long-term resident dies within 10 years of citizenship relinquishment or residency termination. This rule prevents former citizens and former long-term residents who are subject to the alternative tax regime from avoiding U.S. estate tax through the expedient of transferring U.S.-situated assets to a foreign corporation (subject to income tax on any appreciation under section 367). In addition, under the alternative tax regime, the individual is subject to gift tax on

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[138] The alternative tax regime applies to long-term residents of the United States that have terminated their residency with a principal purpose of avoiding U.S. tax. A "long-term resident" is any individual who was a lawful permanent resident of the United States for at least 8 out of the 15 taxable years ending with the year in which such termination occurs. In applying the 8-year test, an individual is not considered to be a lawful permanent resident for any year in which the individual is treated as a resident of another country under a treaty tiebreaker rule (and the individual does not elect to waive the benefits of such treaty).

gifts of U.S.-situated intangibles, such as U.S. stock, made during the 10 years following citizenship relinquishment or residency termination.

Anti-abuse rules are provided to prevent the circumvention of the alternative tax regime. Accordingly, the alternative tax regime generally applies to exchanges of property that give rise to U.S.-source income for property that gives rise to foreign source income. In addition, amounts earned by former citizens and former long-term residents through controlled foreign corporations are subject to the alternative tax regime, and the 10-year liability period is suspended during any time at which a former citizen's or former long-term resident's risk of loss with respect to property subject to the alternative tax regime is substantially diminished, among other measures.

A U.S. citizen who relinquishes citizenship or a long-term resident who terminates residency is treated as having done so with a principal purpose of tax avoidance (and, thus, generally is subject to the alternative tax regime described above) 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. Certain categories of individuals 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.

Under present law, the Immigration and Nationality Act governs the determination of when a U.S. citizen is treated for U.S. Federal tax purposes as having relinquished citizenship. Similarly, 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). In view of this reliance on immigration-law status, it is possible in many instances for a U.S. citizen or resident to convert his or her Federal tax status to that of a nonresident noncitizen without notifying the IRS.

Individuals subject to the alternative tax regime are required to provide certain tax information, including tax identification numbers, upon relinquishment of citizenship or termination of residency (on IRS Form 8854, Expatriation Initial Information Statement). In the case of an individual with a net worth of at least $500,000, the individual also must provide detailed information about the individual's assets and liabilities. The penalty for the failure to provide the required tax information is the greater of $1,000 or five percent of the tax imposed under the alternative tax regime for the year.[139] In addition, the U.S. Department of State and other governmental agencies are required to provide this information to the IRS.

Former citizens and former long-term residents who are subject to the alternative tax regime also are required to file annual income tax returns, but only in the event that they owe

[139] The penalty applies for each year of the 10-year period beginning on the date the individual ceases to be a U.S. citizen or resident.

U.S. Federal income tax. If a tax return is required, the former citizen or former long-term resident is required to provide the IRS with a statement setting forth (generally by category) all items of U.S.-source and foreign-source gross income, but no detailed information with respect to all assets held by the individual.

Reasons for Change

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 residency 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 provision 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.[140]

Objective rules for the alternative tax regime

The provision 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 provision, 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 $122,000 (adjusted for inflation) 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 provision replace the present-law inquiry into the taxpayer's intent. In addition, the provision eliminates the present-law process of IRS ruling requests.

If a former citizen exceeds the monetary thresholds, that person is excluded from the alternative tax regime if he or she falls within the exceptions for certain dual citizens and minors (provided that the requirement of certification and proof of compliance with Federal tax obligations is met). These exceptions provide relief to individuals who have never had substantial connections with the United States, as measured by certain objective criteria, and eliminate IRS inquiries as to the subjective intent of such taxpayers.

In order to be excepted from the application of the alternative tax regime under the provision, 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

[140] 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.

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 should continue to verify that the information submitted was accurate, and it is intended that the IRS should randomly audit such persons to assess compliance.

Termination of U.S. citizen or long-term resident status for U.S. Federal income tax purposes

Under the provision, 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.

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, with no exceptions. The present-law exceptions from being treated as present in the United States for residency purposes[141] do not apply for this purpose.

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 provision, 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

[141] Sections 7701(b)(3)(D), 7701(b)(5) and 7701(b)(7)(B)-(D).

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 gift) bears to the total fair market value of all assets owned by such foreign corporation (at the time of 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 provision requires former citizens and former long-term residents to file an annual return for each year following citizenship relinquishment or residency termination in which they are subject to the alternative tax regime. The annual return is required even if no U.S. Federal income tax is due. The annual return requires certain information, including information on the permanent home of the individual, the individual's country of residency, 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 provision.

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 provisions apply to individuals who relinquish citizenship or terminate long-term residency after February 27, 2003.

II. BUDGET EFFECTS OF THE BILL

A. Committee Estimates

In compliance with paragraph 11(a) of Rule XXVI of the Standing Rules of the Senate, the following statement is made concerning the estimated budget effects of the revenue provisions of the "Energy Tax Incentives Act of 2003" as reported.

[Insert revenue table]

B. Budget Authority and Tax Expenditures

Budget authority

In compliance with section 308(a)(1) of the Budget Act, the Committee states that the revenue provisions of the bill as reported involve no new or increased budget authority.

Tax expenditures

In compliance with section 308(a)(2) of the Budget Act, the Committee states that the revenue-reducing provisions of the bill involve increased tax expenditures (see revenue table in Part III. A., above).

C. Consultation with Congressional Budget Office

In accordance with section 403 of the Budget Act, the Committee advises that the Congressional Budget Office submitted the following statement on this bill:

[Insert CBO statement]

III. VOTES OF THE COMMITTEE

In compliance with paragraph 7(b) of Rule XXVI of the standing rules of the Senate, the following statements are made concerning the roll call votes in the Committee's consideration of the "Energy Tax Incentives Act of 2003."

Motion to report the Bill

An original bill, the "Energy Tax Incentives Act of 2003," was ordered favorably reported, by a record vote on April 2, 2003.

Yeas. - Senators Grassley, Hatch, Lott, Snowe, Thomas, Santorum (proxy), Frist (proxy), Smith, Bunning, Baucus, Rockefeller (proxy), Daschle (proxy), Breaux, Conrad (proxy), Jeffords (proxy), Bingaman (proxy), Kerry (proxy), Lincoln.

Nays. - Senators Nickles, Kyl.

Votes on other amendments

The Committee accepted an amendment by Senator Bingaman to expand the research credit to 100 percent of expenses for energy related research by universities and 20 percent for payments to research consortiums for energy research. The Committee rejected a motion by Senators Baucus and Graham, to extend Superfund taxes, by record vote.

Yeas. - Senators Snowe, Baucus, Rockefeller, Daschle, Conrad, Graham (proxy), Jeffords, Bingaman, Kerry (proxy).

Nays. - Senators Grassley, Hatch, Nickles, Lott, Kyl, Thomas, Santorum, Frist (proxy), Smith, Bunning, Breaux, Lincoln.

The Committee rejected a motion by Senators Baucus, Rockefeller, Daschle, Breaux, Conrad, Graham, Jeffords, Bingaman, Kerry and Lincoln regarding tax shelter transparency and enforcement, by record vote.

Yeas. - Baucus, Rockefeller, Daschle, Breaux, Conrad, Graham (proxy), Jeffords, Bingaman, Kerry (proxy), Lincoln.

Nays. - Senators Grassley, Hatch, Nickles, Lott, Snowe, Kyl, Thomas, Santorum, Frist (proxy), Smith, Bunning.

The Committee rejected a modified amendment by Senator Jeffords, regarding the motor fuel excise tax on diesel fuel used by railroads, by record vote.

Yeas. - Baucus, Rockefeller (proxy), Jeffords, Kerry (proxy).

Nays. - Grassley, Hatch (proxy), Nickles, Lott, Snowe, Kyl, Thomas, Santorum (proxy), Frist (proxy), Smith, Bunning, Daschle, Breaux, Conrad, Bingaman, Lincoln.

The Committee accepted an amendment by Senator Lott regarding the immediate repeal of 4.3 cents tax on diesel used by rails and barges, by voice vote.

The Committee accepted an amendment by Senator Conrad to provide credit for business installations of stationary microturbine power plants. (Senator Kyl objected.)

The Committee rejected an amendment by Senator Nickles to strike section 29 of the Chairman's mark, by roll call vote.

Ayes. - Senators Nickles, Lott, Kyl, Bunning.

Nays. - Senators Grassley, Hatch (proxy), Snowe, Thomas, Santorum (proxy), Frist (proxy), Smith, Baucus, Rockefeller (proxy), Daschle (proxy), Breaux, Conrad (proxy), Graham (proxy), Jeffords (proxy), Bingaman (proxy), Kerry (proxy), Lincoln.

The Committee accepted an amendment by Senator Lincoln to modify section 29 of the Internal Revenue Code with respect to the definition of a landfill gas facility and to modify section 45 of the Internal Revenue Code for the production of electricity to include electricity produced from facilities that burn municipal solid waste. The amendment was modified to include the President's Budget Proposal of definition change for landfill gas placed in service date and to amend the extension of Internal Revenue Service user fees.

IV. REGULATORY IMPACT AND OTHER MATTERS

A. Regulatory Impact

Pursuant to paragraph 11(b) of Rule XXVI of the Standing Rules of the Senate, the Committee makes the following statement concerning the regulatory impact that might be incurred in carrying out the provisions of the bill as amended.

Impact on individuals and businesses

With respect to individuals and businesses, the bill modifies the rules relating to (1) tax benefits for alternative fuels; (2) coal production; (3) oil and gas production; (4) energy conservation; and (5) electric industry participants involved in industry restructuring activities. Taxpayers may elect whether to avail themselves of the provisions of the bill. Thus, the provisions do not impose increased regulatory burdens on individuals or businesses. Certain provisions of the bill, such as the provision relating to transfers of decommissioning funds associated with nuclear generating facilities, simplify the present-law rules and, therefore, reduce burdens on taxpayers electing to utilize the provision. Thus, the bill does not impose increased regulatory burdens on individuals and businesses.

Impact on personal privacy and paperwork

The provisions of the bill do not impact personal privacy. Individuals may elect whether to avail themselves of the provisions of the bill. Thus, the bill does not impose increased paperwork burdens on individuals. Individuals who elect to take advantage of the bill may in some cases need to keep records in order to demonstrate that they qualify for the tax treatment provided by the bill. In some cases the bill simplifies present law, thus reducing recordkeeping requirements.

B. Unfunded Mandates Statement

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

The Committee has determined that four of the revenue provisions of the bill impose Federal mandates on the private sector. The four provisions are (1) the provisions to curtail tax shelters; (2) tax treatment of corporate inversion transactions; (3) the excise tax on stock compensation of insiders of inverted corporations; and (4) the revisions to the alternative tax regime for individuals who expatriate. The Committee has determined that the remaining revenue provisions of the bill do not impose a Federal intergovernmental mandate on State, local, or tribal governments.

C. 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 Senate

Committee on Finance, the House Committee on Ways and Means, or any committee of conference if the legislation includes a provision that directly or indirectly amends the Internal Revenue Code (the "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

In the opinion of the Committee, it is necessary in order to expedite the business of the Senate, to dispense with the requirements of paragraph 12 of Rule XXVI of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill as reported by the Committee).