DESCRIPTION OF H.R. 1531, THE "ENERGY TAX POLICY ACT OF 2003"

Scheduled for Markup
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HOUSE COMMITTEE ON WAYS AND MEANS
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INTRODUCTION

The House Committee on Ways and Means has scheduled a markup on April 3, 2003, on H.R. 1531, the "Energy Tax Policy Act of 2003." This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the "Energy Policy Tax Act of 2003."

[1] This document may be cited as follows: Joint Committee on Taxation, *Description of H.R. 1531, the "Energy Tax Policy Act of 2003"* (JCX-30-03), April 2, 2003.

I. CONSERVATION

A. Tax Credit for Residential Solar Energy

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 personal tax credit for residential solar energy property.

Description of Proposal

The proposal provides a personal tax credit for the purchase of 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 of qualified investment up to a maximum credit of $2,000 for solar water heating property and $2,000 for rooftop photovoltaic property. This credit is nonrefundable, and the depreciable basis of the property is reduced by the amount of the credit.

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. Expenditures for labor costs allocable to onsite preparation, assembly, or original installation of property eligible for the credit are eligible expenditures.

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.

Effective Date

The credit applies to purchases in taxable years ending after December 31, 2003 and before January 1, 2007 (January 1, 2009 in the case of qualified photovoltaic property).

B. Extension and Modification of the Section 45 Electricity Production Credit

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).

Description of Proposal

The proposal extends the placed in service date for wind facilities and closed-loop biomass facilities to facilities placed in service after December 31, 1993 (December 31, 1992 in the case of closed-loop biomass facilities) and before January 1, 2007.

The proposal also defines three new qualifying facilities: open-loop biomass facilities, landfill gas facilities, and trash-to-energy facilities. Open-loop 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 defined as mill as 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 open-loop biomass does not include municipal solid waste (garbage) or paper that is commonly recycled. Landfill gas is defined as methane gas derived from the biodegradation of municipal solid waste. Trash-to-energy facilities are facilities that burn municipal solid waste (garbage) to produce steam to drive a turbine for the production of electricity. Qualifying open-loop biomass facilities and qualifying landfill gas facilities include facilities used to produce electricity placed in service before January 1, 2007. Qualifying trash-to-energy facilities include facilities placed in service after the date of enactment and before January 1, 2007.

In the case of qualifying open-loop biomass facilities and qualifying landfill gas facilities placed in service on or before the date of enactment, the taxpayer may claim the section 45 production credit for only five years, commencing on the date of enactment. In the case of qualifying open-loop biomass facilities and qualifying landfill gas facilities placed in service on or before the date of enactment, the taxpayer may claim two-thirds of the otherwise allowable credit for electricity produced at the facility. In the case of qualifying open-loop biomass facilities originally placed in service on or before the date of enactment, a lessee or operator may claim the credit in lieu of the owner of the qualifying facility.

In the case of qualifying open-loop biomass facilities, the reduction in credit by reason of grants, tax-exempt bonds, subsidized energy financing, and other credits cannot exceed 50 percent.

No facility that previously claimed or currently claims credit under section 29 of the Code is a qualifying facility for purposes of section 45.

Effective Date

The proposal is effective for electricity sold from qualifying facilities after the date of enactment.

C. Tax Incentives for Fuel Cells

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 fuel cell power plant property.

Description of Proposal

The proposal provides a 10 percent credit for the purchase of qualified fuel cell power plants for businesses and individuals. 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. The credit may not exceed $500 for each 0.5 kilowatt of capacity. For individuals, 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 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 December 31, 2003 and before January 1, 2007, 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). The credit for individuals applies to expenditures made after December 31, 2003 and before January 1, 2007.

D. Modifications of Provisions Relating to Electric Vehicles and Clean-Fuel Vehicles

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.

Description of Proposal

Electric vehicles

The proposal repeals the phased down reduction in the credit for years 2004, 2005, and 2006. Thus, the proposal provides that a taxpayer could claim the full 10-percent credit (up to a $4,000) maximum for the purchase of qualified electric vehicles before January 1, 2007.

Clean-fuel vehicles

The proposal repeals the phased down reduction in the allowable deduction for years 2004, 2005, and 2006. Thus, the proposal provides that a taxpayer could claim a full deduction for allowable costs of clean-fuel vehicles purchased before January 1, 2007.

Effective Date

The proposal is effective on the date of enactment.

E. Credit for Energy Efficiency Improvements to Existing Homes

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.

Description of Proposal

The proposal provides a 20-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 $2,000. A qualified energy efficiency improvement is any energy efficiency building envelope component that is certified (in the case of expenditures that exceed $1,000) to meet or exceed the prescriptive criteria for such a component established by the 2000 International Energy Conservation Code (or, in the case of metal roofs with appropriate pigmented coatings, meets the Energy Star program requirements), and (1) is installed in or on a dwelling located in the United States; (2) is 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 reasonably can be expected to remain in use for at least five years.

Building envelope components are: (1) insulation materials or systems which are specifically and primarily designed to reduce the heat loss or gain for a dwelling; (2) exterior windows (including skylights) and doors; and (3) metal roofs with appropriate pigmented coating which are specifically and primarily designed to reduce the heat loss or gain for a dwelling.

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

Effective Date

The credit is effective for qualified energy efficiency improvements installed after December 31, 2003 and before January 1, 2007.

F. Business Credit for Construction of New Energy-Efficient Homes

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.

Description of Proposal

The proposal provides a credit to an eligible contractor (up to $2,000 per dwelling) 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 eligible contractor is the person who constructs 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, exterior windows and doors, metal roofs with appropriate pigmented coatings) and any energy-efficient heating or cooling appliance.

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; (3) certified to have a level of annual heating and cooling energy consumption that is at least 30 percent below the annual level of heating and cooling energy consumption of a comparable dwelling constructed in accordance with the standards of the 2000 International Energy Conservation Code; and (4) with respect to the building envelope alone, certified to have a level of annual heating and cooling energy consumption that is 10 percent below the annual level of heating and cooling energy consumption of a comparable dwelling constructed in accordance with the standards of the 2000 International Energy Conservation Code.

Effective Date

The credit applies to homes whose construction is substantially completed after December 31, 2003, and which are purchased during the period beginning on January 1, 2004, and ending on December 31, 2006.

G. Energy Credit for Combined Heat and Power System Property

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.

Description of Proposal

The proposal provides a 10 percent credit for the purchase of combined heat and power property.

CHP property is 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.)

CHP property does not 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 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 December 31, 2003 and before January 1, 2007.

H. Allow Nonbusiness Energy Credits Against the Alternative Minimum Tax

Present Law

Present law imposes an alternative minimum tax on individuals in an amount equal to the excess of the tentative minimum tax over the regular tax liability. The tentative minimum tax is an amount equal to specified rates of tax imposed on the excess of the alternative minimum taxable income over an exemption amount.

Generally, for taxable years beginning after December 31, 2003, nonrefundable personal credits may not exceed the excess of the regular tax liability over the tentative minimum tax.

Description of Proposal

The proposal allows the personal energy credits added by the bill to offset both the regular tax and the alternative minimum tax.

Effective Date

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

I. Repeal Certain Excise Taxes on Rail Diesel Fuel and Inland Waterway Barge Fuels

Present Law

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

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 are 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.

Description of Proposal

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 proposal.

Effective Date

The proposal is effective on October 1, 2003.

J. Btu-Based Rate for Diesel-Water Fuel Emulsion

Present Law

A 24.3-cents-per-gallon excise tax is imposed on diesel fuel to finance the Highway Trust Fund. Gasoline and most special motor fuels are subject to tax at 18.3 cents per gallon for the Trust Fund. The statutory rate for certain special motor fuels is determined on an energy equivalent basis, as follows:

Liquefied petroleum gas (propane)	13.6 cents per gallon
Liquefied natural gas	11.9 cents per gallon
Methanol derived from petroleum or natural gas	9.15 cents per gallon
Compressed natural gas	48.54 cents per MCF

No special tax rate is provided for diesel fuel blended with water to form a diesel-water fuel emulsion.

Description of Proposal

A special tax rate of 19.7 cents per gallon is provided for diesel fuel blended with water into a diesel-water fuel emulsion to reflect the reduced Btu content per gallon resulting from the water. Emulsion fuels eligible for the special rate consists of not more than 86 percent diesel (and other minor chemical additives to enhance combustion) and at least 14 percent water. Anyone who separates the diesel fuel from the diesel-water fuel emulsion on which a reduced rate of tax was imposed is treated as a refiner of the fuel and is liable for the difference between the amount of tax on the latest removal of the separated fuel and the amount of tax that was imposed upon the pre-mixture removal.

Effective Date

The proposal applies to fuels removed after September 30, 2003.

II. RELIABILITY

A. Natural Gas Gathering Lines Treated as Seven-Year Property

Present Law

The applicable recovery period for assets placed in service under the Modified Accelerated Cost Recovery System is based on the "class life of the property." The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.[2] 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).[3] 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).[4]

Description of Proposal

The proposal establishes a statutory seven-year recovery period and a class life of 10 years for natural gas gathering lines. In addition, the proposal provides that there would be no adjustment to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to such property. 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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[2] 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

[3] *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).

[4] *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 proposal 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.

B. Natural Gas Distribution Lines Treated as Fifteen-Year Property

Present Law

The applicable recovery period for assets placed in service under the Modified Accelerated Cost Recovery System is based on the "class life of the property." The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.[5] Natural gas distribution pipelines are assigned a 20-year recovery period and a class life of 35 years.

Description of Proposal

The proposal establishes a statutory 15-year recovery period and a class life of 20 years for natural gas distribution lines. In addition, the proposal provides that there would be no adjustment to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to such property.

Effective Date

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

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[5] 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

C. Transmission Property Treated as Fifteen-Year Property

Present Law

The applicable recovery period for assets placed in service under the Modified Accelerated Cost Recovery System is based on the "class life of the property." The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.[6] Assets used in the transmission and distribution of electricity for sale and related land improvements are assigned a 20-year recovery period and a class life of 30 years.

Description of Proposal

The proposal establishes a statutory 15-year recovery period and a class life of 20 years for certain assets used in the transmission of electricity for sale and related land improvements. For purposes of the proposal, section 1245 property used in the transmission of electricity for sale at 69 kilovolts and above will qualify for the new recovery period. In addition, the proposal provides that there would be no adjustment to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to such property.

Effective Date

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

[6] 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

D. Expensing of Capital Costs Incurred and Credit for Production in Complying with Environmental Protection Agency Sulfur Regulations

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.

Description of Proposal

The proposal permits small business refiners to claim an immediate deduction (i.e., expensing) for up to 75 percent of the costs paid or incurred for the purpose of complying with the Highway Diesel Fuel Sulfur Control Requirements of the Environmental Protection Agency. In addition, the proposal provides that a small business refiner may claim credit equal to five cents per gallon for each gallon of low sulfur diesel fuel produced during the taxable year. The total production credit claimed by the taxpayer is limited to 25 percent of the capital costs incurred to come into compliance with the EPA diesel fuel requirements. The taxpayer's basis in such property is reduced by the amount of production credit claimed.

For these purposes a small business refiner is a taxpayer who within the business of refining petroleum products engages not more than 1,500 persons directly in refining on business days and has less that 205,000 barrels per day of total domestic refinery capacity.[7] The credit and deduction phase out for refiners with capacity in excess of 155,000 barrels per day.

Effective Date

The proposal would be effective for expenses paid or incurred after March 31, 2003.

[7] The refining capacities of all persons that are part of a related group are aggregated for purposes of this definition.

E. Determination of Small Refiner Exception to Oil Depletion Deduction

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.

Description of Proposal

The proposal increases the current 50,000 barrel per day limitation to 75,000. In addition, the proposal 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 may not exceed 75,000 barrels. For this purpose, the taxpayer calculates average daily production by dividing total production for the taxable year by the total number of days in the taxable year.

Effective Date

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

F. Sales or Dispositions to Implement Federal Energy Regulatory Commission or State Electric Restructuring Policy

Present Law

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

Description of Proposal

The proposal 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 if the amount realized from such sale is used to purchase exempt utility property within the applicable period[8] (the "reinvestment property"). If the amount realized exceeds the amount used to purchase reinvestment property, any realized gain shall be recognized to the extent of such excess in the year of the qualifying electric transmission transaction. Any remaining realized gain is recognized ratably over the eight-year period.

A qualifying electric transmission transaction is the sale or other disposition of property used by the taxpayer in the trade or business of providing electric transmission services, or an ownership interest in such an entity, to an independent transmission company prior to January 1, 2007. In general, an independent transmission company is defined as: (1) an independent transmission provider[9] approved by the FERC; (2) a person (i) who the FERC determines under section 203 of the Federal Power Act (or by declaratory order) is not a "market participant" and (ii) whose transmission facilities are placed under the operational control of a FERC-approved independent transmission provider before the close of the period specified in such authorization, but not later than January 1, 2007; or (3) in the case of facilities subject to the jurisdiction of the Public Utility Commission of Texas, (i) a person which is approved by that Commission as consistent with Texas State law regarding an independent transmission organization, or (ii) a political subdivision, or affiliate thereof, whose transmission facilities are under the operational control of an organization described in (i).

Exempt utility property is defined as: (1) property used in the trade or business of generating, transmitting, distributing, or selling electricity or producing, transmitting, distributing, or selling natural gas, or (2) stock in a controlled corporation whose principal trade or business consists of the activities described in (1).

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[8] The applicable period for a taxpayer to reinvest the proceeds is four years after the close of the taxable year in which the qualifying electric transmission transaction occurs.

[9] For example, a regional transmission organization, an independent system operator, or and independent transmission company.

If a taxpayer is a member of an affiliated group of corporations filing a consolidated return, the proposal permits the reinvestment property to be purchased by any member of the affiliated group (in lieu of the taxpayer).

If a taxpayer elects the provisions of the proposal, then the statutory period for the assessment of any deficiency, for any taxable year in which any part of the gain eligible for the proposal is realized, attributable to such gain shall not expire prior to the expiration of three years from the date the Secretary of the Treasury is notified by the taxpayer of the reinvestment property or an intention not to reinvest.

A taxpayer electing the provisions of the proposal 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.[10] In addition, a taxpayer electing the provisions of the proposal is required to attach a statement that identifies the reinvestment property in the manner as the Secretary shall prescribe.

Effective Date

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

[10] The proposal also provides that the installment sale rules shall not apply to any qualifying electric transmission transaction that elects the provisions of this proposal.

G. Modification to Special Rules for Nuclear Decommissioning Costs

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.[11]

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").[12] 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 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

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[11] 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.

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

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.[13] The transferee is required to obtain a new ruling amount from the IRS or accept a discretionary determination by the IRS.[14]

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.[15] 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.

Description of Proposal

Repeal of cost of service requirement

The proposal repeals the cost of service requirement for deductible contributions to a nuclear decommissioning fund. Thus, all taxpayers, including unregulated taxpayers, are 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

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

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

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

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.

Exception to ruling amount for certain decommissioning costs

The proposal 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, is not permitted to be accumulated in a qualified fund (generally pre-1984 decommissioning costs).[16] 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.[17] If a qualified fund that has received amounts under this rule is transferred to another person, the transferor will be permitted a deduction for any remaining deductible amounts at the time of transfer.

Contributions to a qualified fund after useful life of powerplant

The proposal also allows deductible contributions to a qualified fund subsequent to the end of a nuclear powerplant's estimated useful life. Such payments are permitted to the extent they do not cause the assets of the qualified fund to exceed the present value of the taxpayer's allocable share (current or former) of the nuclear decommissioning costs of such nuclear powerplant.

Clarify treatment of transfers of qualified funds

The proposal 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 as a result of the transfer

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[16] 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).

[17] 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 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.

of a qualified fund in connection with the transfer of the power plant with respect to which such fund was established.

Effective Date

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

H. Treatment of Certain Income of Electric Cooperatives

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).[18]

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,

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[18] 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.[19]

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).[20] 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.

Description of Proposal

Treatment of income from open access transactions

The proposal provides that income received or accrued by a rural electric cooperative (other than income received or accrued directly or indirectly from a member of the cooperative) from the provision or sale of electric energy transmission services or ancillary services on a nondiscriminatory open access basis under an independent transmission provider agreement approved by FERC (including an agreement providing for the transfer of control--but not

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

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

ownership--of transmission facilities)[21] is excluded in determining whether a rural electric cooperative satisfies the 85-percent test for tax exemption under section 501(c)(12).

For purposes of the 85-percent test, the proposal also provides that income received or accrued by a rural electric cooperative 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, provided that such income is derived from a "like organization" activity of the cooperative under present law.[22]

Treatment of income from nuclear decommissioning transactions

The proposal 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 proposal 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 proposal 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.

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[21] Under this proposal, references to FERC are treated as including references to the Public Utility Commission of Texas.

[22] *See, e.g.,* Rev. Rul. 2002-54, 2002-37 I.R.B. 527; Rev. Rul. 83-170, 1983-2 C.B. 97; Rev. Rul. 65-201, 1965-2 C.B. 170

Treatment of income from load loss transactions

Tax-exempt rural electric cooperatives–The proposal 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 proposal 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 proposal 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 proposal 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 proposal 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 proposal is effective for taxable years beginning after the date of enactment.

I. Exempt Certain Prepayments for Natural Gas From Tax-Exempt Bond Arbitrage Rules

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.[23] 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." The term investment-type property includes the acquisition of property in a transaction involving a prepayment. 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.[24] 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 retain 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.[25]

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 it is not dependent on performance by any person (other than the party to the swap contract) under another contract (for example, a gas contract or another swap contract).

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[23] Sec. 103.

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

[25] See Treas. Reg. 1.141-12.

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 swap contract is a hedge.[26] The Commissioner may, by published guidance, set forth additional circumstances in which a prepayment does not give rise to investment-type property.

Description of Proposal

In general

The proposal 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 proposal also provides such prepayments are not treated as private loans for purposes of the private business tests.

Under the proposal, 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 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.

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 contract for any period is to be reduced by 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).[27] For purposes of the

[26] 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).

[27] 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.

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 government utility enters into a contract to supply natural gas (other than for resale) for a commercial person for use 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 (1) the volume of natural gas covered by the prepayment to be in excess of that needed for 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.

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 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 amount permitted by the exception is insufficient.

Effective Date

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

J. Prepayment of Premium Liability for Coal Miner Health Benefits

Present Law

The United Mine Workers of America ("UMWA") Combined Benefit Fund was established by the Coal Industry Retiree Health Benefit Act of 1992 (the "Coal Act") to assume responsibility of payments for medical care expenses of retired miners and their dependents who were eligible for heath care from the private 1950 and 1974 UMWA Benefit Plans. The Combined Benefit Fund is financed by assessments on current and former signatories to labor agreements with the UMWA, past transfers from an overfunded United Mine Workers pension fund, and transfers from the Abandoned Mine Reclamation Fund. The Social Security Administration is responsible for assigning eligible retired miners and their dependents to current and former signatories to labor agreements with the UMWA and calculating annual contributions to be paid by each such signatory for each beneficiary assigned to the signatory. The Coal Act uses the term "assigned operator" to refer to the signatory to which liability for a particular beneficiary of the Combined Benefit Fund has been assigned. Under the Coal Act, related persons to signatories to the relevant labor agreements may have liability for premium payments. In addition, successors to assigned operators may also have such liability.

Description of Proposal

The proposal allows assigned operators that are members of a controlled group of corporations to prepay their premium liability to the Combined Benefit Fund. Under the proposal, only the common parent (and no other person) is liable for the premiums of an assigned operator which is a member of the parent's controlled group if: (1) the assigned operator makes a payment to the Combined Benefit Fund meeting certain requirements; (2) the parent is jointly and severally liable for any premium which would otherwise be required to be paid by the operator; and (3) the parent provides certain security.

Under the proposal, in order for the relief from liability to apply to the assigned operator: (1) the payment by the assigned operator (described in (1) above) must be no less than the present value of the total premium liability of the assigned operator, as determined by the operator's enrolled actuary, using actuarial methods and assumptions each of which is reasonable and which are reasonable in the aggregate (as determined by such actuary); (2) the enrolled actuary must file with the Department of Labor an actuarial report regarding the valuation made by the actuary; and (3) the parent must file a description of the security provided with the Secretary of Labor. The Secretary of Labor has 30 days after the filing of the reports in (2) and (3) to notify the operator if the Secretary believes the applicable requirements have not been satisfied.

The security provided by the parent must be provided to the trustees of the 1992 UMWA Benefit Plan, solely for the purpose of paying premiums for eligible beneficiaries, and must be equal to one year's premium liability of the assigned operator (determined using the average cost of the operator's liability during the prior three years). The security must remain in place for five years. The security must in the form of a bond, letter of credit or cash escrow.

Any prepayment made under the provision is to be used exclusively to pay premiums for which the operator would otherwise be liable.

Effective Date

The provision is effective on the date of enactment.

III. PRODUCTION

A. Tax Credit for Oil and Gas Production From Marginal Wells

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.

[Present law imposes an alternative minimum tax on individuals and corporations in an amount equal to the excess of the tentative minimum tax over the regular tax liability. The tentative minimum tax is an amount equal to specified rates of tax imposed on the excess of the alternative minimum taxable income over an exemption amount. Generally, business credits may not exceed the excess of the regular tax liability over the tentative minimum tax.]

Description of Proposal

The proposal creates a new, $3 per barrel credit for the production of crude oil and a $0.50 per 1,000 cubic feet of qualified natural gas production. The maximum amount of production on which credit can be claimed is 1,095 barrels or barrel equivalents. In both cases, the credit is available only for production from a "qualified marginal well." The credit is not available to production occurring if the reference price of oil exceeds $18 ($2.00 for natural gas). The credit is reduced proportionately 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.

A qualified marginal well is defined as (1) a domestic well the production from which is treated as marginal production for purposes of the Code percentage depletion rules or (2) a domestic 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 a general business credit but is allowed against the alternative minimum tax. Additionally, unused credits can be carried back for up to 10 years rather than the generally applicable carryback period of one year.

Effective Date

The proposal is effective for production in tax years beginning after December 31, 2003.

B. Temporary Suspension of Limitation Based on 65 Percent of Taxable Income and Extension of Suspension of Taxable Income Limit With Respect to Marginal Production

Present Law

In general

Overview of Depletion

Depletion like depreciation, is a form of capital cost recovery. In both cases, the taxpayer is allowed a deduction in recognition of the fact that an asset--in the case of depletion for oil or gas interests, the mineral reserve itself--is being expended in order to produce income. Certain costs incurred prior to drilling an oil or gas property are recovered through the depletion deduction. These include costs of acquiring the lease or other interest in the property and geological and geophysical costs (in advance of actual drilling).

Depletion is available to any person having an economic interest in a producing property. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in minerals in place, and secures, by any form of legal relationship, income derived from the extraction of the mineral, to which it must look for a return of its capital.[28] 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.[29] 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

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

[29] Sec. 613A.

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. 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)).[30] 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,[31] 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.

[30] 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.

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

Description of Proposal

The limit on percentage depletion deductions to no more than 65 percent of the taxpayer's overall taxable income is suspended for taxable years beginning after December 31, 2003, and before January 1, 2007. The suspension of the 100-percent net-income limitation for marginal wells is extended an additional three years, through taxable years beginning before January 1, 2007.

Effective Date

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

C. Amortization of Delay Rental Payments

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. The Treasury Department has taken the position that the uniform capitalization rules of section 263A require delay rental payments to be capitalized.

Description of Proposal

The proposal 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 proposal applies to delay rental payments paid or incurred in taxable years beginning after December 31, 2003. No inference is intended from the prospective effective date of this proposal as to the proper treatment of pre-effective date delay rental payments.

D. Amortization of Geological and Geophysical Expenditures

Present Law

In general

Geological and geophysical expenditures ("G&G costs") 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.[32]

Courts have held that G&G costs are capital, and therefore are allocable to the cost of the property[33] acquired or retained.[34] 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 G&G costs.

Revenue Ruling 77-188

In Revenue Ruling 77-188[35] (hereinafter referred to as the "1977 ruling"), the IRS provided guidance regarding the proper tax treatment of G&G 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

[32] 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).

[33] "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.

[34] 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.

[35] 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 G&G 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 G&G 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 G&G 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 G&G 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,[36] 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."

Description of Proposal

The proposal 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 proposal is effective for G&G costs paid or incurred in taxable years beginning after December 31, 2003. 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.

[36] 1983-2 C.B. 51.

E. Extension and Modification of Credit for Producing Fuel From a Non-Conventional Source

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)[37] per barrel or BTU oil barrel equivalent (sec. 29). Qualified fuels must be produced within the United States.

Qualified fuels include:

(1) oil produced from shale and tar sands;

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

(3) 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).

Description of Proposal

The proposal permits taxpayers to claim the sec. 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. Qualifying fuels are oil from shale or tar sands, and gas from geopressured brine, Devonian shale, coal seams or a tight formation. The value of the credit is $3.00 for production in 2003 and is indexed for inflation commencing with the credit amount for 2004. The credit could be claimed for production from the well for each of the first four years of production, but not for any production occurring after December 31, 2009.

[37] The value of the section 29 credit for production in 2001 was $6.28 per barrel of oil equivalent.

The proposal further permits production from certain existing wells (any well drilled after December 31, 1979 and before January 1, 1993) to claim a credit equal to the newly, re-indexed value of $3.00 for production in 2003 after date of enactment through 2006.

The proposal also permits landfill gas sold to a third party from facilities placed in service after June 30, 1998 and before January 1, 2007 to be eligible for the taxpayer to claim five years of credit from the later of the date of enactment or the date the facility is placed in service. The amount of credit is $3.00 per barrel equivalent in 2003 and is indexed for inflation commencing with the credit amount for 2004. In the case of a landfill subject to the Environmental Protection Agency's 1996 New Source Performance Standards/Emissions Guidelines the amount of credit is $2.00 per barrel equivalent in 2003 and is indexed for inflation commencing with the credit amount for 2004.

Under the proposal, the taxpayer may not 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.[38]

Effective Date

The proposal applies to fuel sold from qualifying wells and facilities after the date of enactment.

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

F. Allow Business Energy Credits Against the Alternative Minimum Tax

Present Law

Present law imposes an alternative minimum tax on individuals and corporations in an amount equal to the excess of the tentative minimum tax over the regular tax liability. The tentative minimum tax is an amount equal to specified rates of tax imposed on the excess of the alternative minimum taxable income over an exemption amount.

Generally, business credits may not exceed the excess of the regular tax liability over the tentative minimum tax.

Description of Proposal

The proposal makes the minimum tax limitation inapplicable to the business energy credits added by the bill.

Effective Date

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

G. Repeal Alternative Minimum Tax Intangible Drilling Costs ("IDC") Preference for Oil and Gas Production

Present Law

Taxpayers who pay or incur intangible drilling or development costs ("IDCs") in the development of domestic oil or gas production may elect to either expense or capitalize these amounts. If an election to expense IDCs is made, the taxpayer deducts the amount of the IDCs as an expense in the taxable year the cost is paid or incurred.

The difference between the amount of a taxpayer's IDC deduction and the amount which would have been currently deductible had IDCs been capitalized and recovered over a 10-year period is an item of tax preference for the alternative minimum tax ("AMT") to the extent that this amount exceeds 65 percent of the taxpayer's net income from oil and gas properties for the taxable year. This preference applies to taxpayers other than integrated oil companies only to the extent that the failure to apply the preference would result in a reduction of the taxpayer's alternative minimum taxable income by more than 40 percent.

Description of Proposal

The proposal repeals the AMT preference for intangible drilling costs for oil and gas wells for taxpayers other than integrated oil companies.

Effective Date

The proposal applies to taxable years beginning after December 31, 2003, and beginning before January 1, 2006.

H. Allow Enhanced Oil Recovery Credit Against the Alternative Minimum Tax

Present Law

Present law imposes an alternative minimum tax on individuals and corporations in an amount equal to the excess of the tentative minimum tax over the regular tax liability. The tentative minimum tax is an amount equal to specified rates of tax imposed on the excess of the alternative minimum taxable income over an exemption amount.

Generally, business credits may not exceed the excess of the regular tax liability over the tentative minimum tax. One of these credits is the enhanced oil recovery credit (sec. 43).

Description of Proposal

The proposal repeals the minimum tax limitation on the enhanced oil recovery credit.

Effective Date

The proposal applies to taxable years beginning after December 31, 2003, and beginning before January 1, 2006.