

**DESCRIPTION OF THE CHAIRMAN'S MODIFICATION  
TO THE PROVISIONS OF THE  
"JOBS AND GROWTH TAX ACT OF 2003"**

Scheduled for Markup  
By the  
SENATE COMMITTEE ON FINANCE  
on May 8, 2003

Prepared by the Staff  
of the  
JOINT COMMITTEE ON TAXATION



May 8, 2003  
JCX-44-03

# CONTENTS

	<u>Page</u>
INTRODUCTION .....	3
I. MODIFICATIONS TO THE JOBS AND GROWTH ACT OF 2003 .....	4
A. Alternative Minimum Tax Exemption Amounts .....	4
B. Partial Exclusion of Dividend Income from Tax .....	5
II. NEW PROVISIONS .....	7
A. Proposals Designed to Curtail Tax Shelters.....	7
1. Clarification of the economic substance doctrine.....	7
2. Penalty for failure to disclose reportable transactions .....	13
3. Modifications to the accuracy-related penalties for listed transactions and reportable transactions having a significant tax avoidance purpose .....	16
4. Penalty for understatements from transactions lacking economic substance .....	20
5. Modifications to the substantial understatement penalty.....	23
6. Tax shelter exception to confidentiality privileges relating to taxpayer communications .....	24
7. Disclosure of reportable transactions by material advisors .....	25
8. Investor lists and modification of penalty for failure to maintain investor lists .....	28
9. Actions to enjoin conduct with respect to tax shelters and reportable transactions.....	30
10. Understatement of taxpayer’s liability by income tax return preparer .....	30
11. Penalty for failure to report interests in foreign financial accounts.....	31
12. Frivolous tax returns and submissions .....	32
13. Penalties on promoters of tax shelters .....	33
14. Extend statute of limitations for certain undisclosed transactions.....	34
15. Deny deduction for interest paid to IRS on underpayments involving certain tax-motivated transactions .....	34
B. Other Proposals.....	36
1. Affirmation of consolidated return regulation authority.....	36
2. Chief Executive Officer Required To Sign Corporate Income Tax Returns .....	41
C. Enron-Related Tax Shelter Related Provisions.....	42
1. Limitation on transfer and importation of built-in losses .....	42
2. No reduction of basis under section 734 in stock held by partnership in corporate partner .....	44
3. Repeal of special rules for FASITs.....	46
4. Expanded disallowance of deduction for interest on convertible debt .....	50
5. Expanded authority to disallow tax benefits under section 269 .....	52
6. Modification of CFC-PFIC coordination rules .....	53
D. Impose Mark-to-Market Tax on Individuals Who Expatriate .....	56
E. Extension of IRS User Fees .....	67
F. Provisions to Discourage Corporate Expatriation.....	68
1. Tax treatment of inversion transactions.....	68
2. Excise tax on stock compensation of insiders of inverted corporations .....	73
3. Reinsurance agreements.....	77

G. Add Vaccines Against Hepatitis A to the List of Taxable Vaccines .....	79
H. Disallowance of Certain Partnership Loss Transfers .....	80
I. Treatment of Stripped Bonds to Apply to Stripped Interests in Bond and Preferred Stock Funds .....	84
J. Reporting of Taxable Mergers and Acquisitions .....	88
K. Inclusion in Gross Income of Certain Deferred Compensation .....	90
L. Minimum Holding Period for Foreign Tax Credit with respect to Withholding Taxes on Income other than Dividends .....	94
M. Permit Private Sector Debt Collection Companies to Collect Tax Debts.....	96
N. Repeal the exclusion for foreign earned income and the exclusion or deduction for housing expenses .....	98
O. Modify Qualification Rules for Tax-Exempt Property and Casualty Insurance Companies .....	100
P. Authorize IRS to Enter into Installment Agreements that Provide for Partial Payment.....	101
Q. Denial of Deduction for Certain Fines, Penalties, and Other Amounts.....	102
R. Deposits Made to Suspend the Running of Interest on Potential Underpayments .....	104
S. Clarification of Rules For Payment of Estimated Tax for Certain Deemed Asset Sales .....	107
T. Limit Deduction for Charitable Contributions of Patents and Similar Property .....	109
U. Temporary State Fiscal Relief Fund .....	110
V. Extension of Customs User Fees .....	111
W. SSI Redetermination .....	112
X. Covering Childless Adults with SCHIP Funds .....	113

## INTRODUCTION

This document<sup>1</sup>, prepared by the staff of the Joint Committee on Taxation, provides a description of the Chairman's modification to the provisions of the "Jobs and Growth Tax Act of 2003." The Senate Committee on Finance has scheduled a markup of this proposal for May 8, 2003.

---

<sup>1</sup> This document may be cited as follows: Joint Committee on Taxation, *Description of the Chairman's Modification to the Provisions of the "Jobs and Growth Tax Act of 2003."* (JCX-44-03), May 8, 2003.

**I. MODIFICATIONS TO  
THE JOBS AND GROWTH ACT OF 2003**

The following modifications are made to the provisions of the Jobs and Growth Act of 2003.

**A. Alternative Minimum Tax Exemption Amounts**

The proposal increases the AMT exemption amount for married taxpayers filing a joint return and surviving spouses to \$61,000, and for unmarried taxpayers to \$41,750, for taxable years beginning in 2003, 2004 and 2005.

## **B. Partial Exclusion of Dividend Income from Tax**

### **Present Law**

Under present law, dividends received by an individual are included in gross income and taxed as ordinary income at rates up to 38.6 percent.<sup>2</sup>

### **Description of Proposal**

Under the proposal, an individual may exclude from gross income the first \$500 (\$250 in the case of a married individual filing a separate return) of dividends received from domestic corporations in a taxable year plus 10 percent (20 percent in the case of taxable years beginning after December 31, 2007) of the dividends received in excess of \$500 (or \$250).

If a shareholder does not hold a share of stock for more than 45 days during the 90-day period beginning 45 days before the ex-dividend date (as measured under section 246(c)),<sup>3</sup> dividends received on the stock are not eligible for the exclusion. Also, the exclusion is not available for dividends to the extent that the taxpayer is obligated to make related payments with respect to positions in substantially similar or related property.

If an individual receives an extraordinary dividend (within the meaning of section 1059(c)) eligible for the exclusion with respect to any share of stock, any loss on the sale of the stock is treated as a long-term capital loss to the extent of the amount of the dividend.

A dividend is treated as investment income for purposes of determining the amount of deductible investment interest only if the taxpayer elects to treat the dividend as not eligible for the exclusion.

The amount of dividends qualifying for the exclusion that may be paid by a regulated investment company or real estate investment trust, for any taxable year that the aggregate qualifying dividends received by the company or trust are less than 95 percent of its gross income (as specially computed), may not exceed the amount of such aggregate dividends received by the company or trust.

The exclusion does not apply to dividends received from an organization that was exempt from tax under section 501 or was a tax-exempt farmers' cooperative in either the taxable year of the distribution or the preceding taxable year; dividends received from a mutual savings bank that received a deduction under section 591; or deductible dividends paid on employer securities.

In the case of a nonresident alien, the exclusion applies only for purposes of determining the taxes imposed pursuant to sections 871(b) and 877.

---

<sup>2</sup> Another provision of the proposal reduces the maximum rate to 35 percent.

<sup>3</sup> In the case of preferred stock, the periods are doubled.

Dividends excluded under the proposal are included in modified adjusted gross income for purposes of the provisions of the Code determining the amount of any income inclusion, exclusion, deduction or credit based on the amount of that income. Also in determining eligibility for the earned income credit, any dividends excluded from gross income under this provision are included in disqualified income for purposes of the determining whether the individual has excessive investment income.

The tax rate for the accumulated earnings tax (sec. 531) and the personal holding company tax (sec. 541) is reduced to 90 percent (80 percent in the case of taxable years beginning after December 31, 2007) of the highest individual tax rate.

Amounts treated as ordinary income on the disposition of certain preferred stock (sec. 306) are treated as dividends for purposes of the proposal.

The collapsible corporation rules (sec. 341) are repealed.

#### **Effective Date**

The proposal is effective for taxable years beginning after December 31, 2003, and beginning before January 1, 2013.

## II. NEW PROVISIONS

### A. Proposals Designed to Curtail Tax Shelters

#### 1. Clarification of the economic substance doctrine

##### Present Law

##### In general

The Code provides specific rules regarding the computation of taxable income, including the amount, timing, source, and character of items of income, gain, loss and deduction. These rules are designed to provide for the computation of taxable income in a manner that provides for a degree of specificity to both taxpayers and the government. Taxpayers generally may plan their transactions in reliance on these rules to determine the federal income tax consequences arising from the transactions.

In addition to the statutory provisions, courts have developed several doctrines that can be applied to deny the tax benefits of tax motivated transactions, notwithstanding that the transaction may satisfy the literal requirements of a specific tax provision. The common-law doctrines are not entirely distinguishable, and their application to a given set of facts is often blurred by the courts and the IRS. Although these doctrines serve an important role in the administration of the tax system, invocation of these doctrines can be seen as at odds with an objective, “rule-based” system of taxation. Nonetheless, courts have applied the doctrines to deny tax benefits arising from certain transactions.<sup>4</sup>

A common-law doctrine applied with increasing frequency is the “economic substance” doctrine. In general, this doctrine denies tax benefits arising from transactions that do not result in a meaningful change to the taxpayer’s economic position other than a purported reduction in federal income tax.<sup>5</sup>

##### Economic substance doctrine

Courts generally deny claimed tax benefits if the transaction that gives rise to those benefits lacks economic substance independent of tax considerations -- notwithstanding that the purported activity actually occurred. The tax court has described the doctrine as follows:

---

<sup>4</sup> See, e.g., *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *aff’d* 73 T.C.M. (CCH) 2189 (1997), *cert. denied* 526 U.S. 1017 (1999).

<sup>5</sup> Closely related doctrines also applied by the courts (sometimes interchangeable with the economic substance doctrine) include the “sham transaction doctrine” and the “business purpose doctrine”. See, e.g., *Knetsch v. United States*, 364 U.S. 361 (1960) (denying interest deductions on a “sham transaction” whose only purpose was to create the deductions).



The tax law . . . requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings.<sup>6</sup>

### Business purpose doctrine

Another common law doctrine that overlays and is often considered together with (if not part and parcel of) the economic substance doctrine is the business purpose doctrine. The business purpose test is a subjective inquiry into the motives of the taxpayer -- that is, whether the taxpayer intended the transaction to serve some useful non-tax purpose. In making this determination, some courts have bifurcated a transaction in which independent activities with non-tax objectives have been combined with an unrelated item having only tax-avoidance objectives in order to disallow the tax benefits of the overall transaction.<sup>7</sup>

### Application by the courts

#### Elements of the doctrine

There is a lack of uniformity regarding the proper application of the economic substance doctrine. Some courts apply a conjunctive test that requires a taxpayer to establish the presence of both economic substance (i.e., the objective component) and business purpose (i.e., the subjective component) in order for the transaction to sustain court scrutiny.<sup>8</sup> A narrower approach used by some courts is to invoke the economic substance doctrine only after a determination that the transaction lacks both a business purpose and economic substance (i.e., the existence of either a business purpose or economic substance would be sufficient to respect the transaction).<sup>9</sup> A third approach regards economic substance and business purpose as “simply

---

<sup>6</sup> *ACM Partnership v. Commissioner*, 73 T.C.M. at 2215.

<sup>7</sup> *ACM Partnership v. Commissioner*, 157 F.3d at 256 n.48.

<sup>8</sup> *See, e.g., Pasternak v. Commissioner*, 990 F.2d 893, 898 (6<sup>th</sup> Cir. 1993) (“The threshold question is whether the transaction has economic substance. If the answer is yes, the question becomes whether the taxpayer was motivated by profit to participate in the transaction.”)

<sup>9</sup> *See, e.g., Rice’s Toyota World v. Commissioner*, 752 F.2d 89, 91-92 (4<sup>th</sup> Cir. 1985) (“To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and, second, that the transaction has no economic substance because no reasonable possibility of a profit exists.”); *IES Industries v. United States*, 253 F.3d 350, 358 (8<sup>th</sup> Cir. 2001) (“In determining whether a transaction is a sham for tax purposes [under the Eighth Circuit test], a transaction will be characterized as a sham if it is not motivated by any economic purpose out of tax considerations (the business purpose test), and if it is without economic substance because no real potential for profit exists” (the economic substance test).”) As noted earlier, the economic substance doctrine and the sham transaction doctrine are similar and sometimes are applied interchangeably. For a

more precise factors to consider” in determining whether a transaction has any practical economic effects other than the creation of tax benefits.<sup>10</sup>

### Profit potential

There also is a lack of uniformity regarding the necessity and level of profit potential necessary to establish economic substance. Since the time of *Gregory*, several courts have denied tax benefits on the grounds that the subject transactions lacked profit potential.<sup>11</sup> In addition, some courts have applied the economic substance doctrine to disallow tax benefits in transactions in which a taxpayer was exposed to risk and the transaction had a profit potential, but the court concluded that the economic risks and profit potential were insignificant when compared to the tax benefits.<sup>12</sup> Under this analysis, the taxpayer’s profit potential must be more than nominal. Conversely, other courts view the application of the economic substance doctrine as requiring an objective determination of whether a “reasonable possibility of profit” from the transaction existed apart from the tax benefits.<sup>13</sup> In these cases, in assessing whether a

---

more detailed discussion of the sham transaction doctrine, *see, e.g.*, Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (including Provisions Relating to Corporate Tax Shelters)* (JCS-3-99) at 182.

<sup>10</sup> *See, e.g.*, *ACM Partnership v. Commissioner*, 157 F.3d at 247; *James v. Commissioner*, 899 F.2d 905, 908 (10<sup>th</sup> Cir. 1995); *Sacks v. Commissioner*, 69 F.3d 982, 985 (9<sup>th</sup> Cir. 1995) (“Instead, the consideration of business purpose and economic substance are simply more precise factors to consider . . . We have repeatedly and carefully noted that this formulation cannot be used as a ‘rigid two-step analysis’.”).

<sup>11</sup> *See, e.g.*, *Knetsch*, 364 U.S. at 361; *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966) (holding that an unprofitable, leveraged acquisition of Treasury bills, and accompanying prepaid interest deduction, lacked economic substance); *Ginsburg v. Commissioner*, 35 T.C.M. (CCH) 860 (1976) (holding that a leveraged cattle-breeding program lacked economic substance).

<sup>12</sup> *See, e.g.*, *Goldstein v. Commissioner*, 364 F.2d at 739-40 (disallowing deduction even though taxpayer had a possibility of small gain or loss by owning Treasury bills); *Sheldon v. Commissioner*, 94 T.C. 738, 768 (1990) (stating, “potential for gain . . . is infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions”).

<sup>13</sup> *See, e.g.*, *Rice’s Toyota World v. Commissioner*, 752 F.2d at 94 (the economic substance inquiry requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits); *Compaq Computer Corp. v. Commissioner*, 277 F.3d at 781 (applied the same test, *citing Rice’s Toyota World*); *IES Industries v. United States*, 253 F.3d at 354 (the application of the objective economic substance test involves determining whether there was a “reasonable possibility of profit . . . apart from tax benefits.”).

reasonable possibility of profit exists, it is sufficient if there is a nominal amount of pre-tax profit as measured against expected net tax benefits.

## **Description of Proposal**

### **In general**

The proposal clarifies and enhances the application of the economic substance doctrine. The proposal provides that a transaction has economic substance (and thus satisfies the economic substance doctrine) only if the taxpayer establishes that (1) the transaction changes in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position, and (2) the taxpayer has a substantial non-tax purpose for entering into such transaction and the transaction is a reasonable means of accomplishing such purpose.<sup>14</sup>

The proposal does not change current law standards used by courts in determining when to utilize an economic substance analysis. Also, the proposal does not alter the court's ability to aggregate or disaggregate a transaction when applying the doctrine. The proposal provides a uniform definition of economic substance, but does not alter court flexibility in other respects.

### **Conjunctive analysis**

The proposal clarifies that the economic substance doctrine involves a conjunctive analysis -- there must be an objective inquiry regarding the effects of the transaction on the taxpayer's economic position, as well as a subjective inquiry regarding the taxpayer's motives for engaging in the transaction. Under the proposal, a transaction must satisfy both tests -- i.e., it must change in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position, and the taxpayer must have a substantial non-tax purpose for entering into such transaction (and the transaction is a reasonable means of accomplishing such purpose) -- in order to satisfy the economic substance doctrine. This clarification eliminates the disparity that exists among the circuits regarding the application of the doctrine, and modifies its application in those circuits in which either a change in economic position or a non-tax business purpose (without having both) is sufficient to satisfy the economic substance doctrine.

### **Non-tax business purpose**

The proposal provides that a taxpayer's non-tax purpose for entering into a transaction (the second prong in the analysis) must be "substantial," and that the transaction must be "a reasonable means" of accomplishing such purpose. Under this formulation, the non-tax purpose

---

<sup>14</sup> If the tax benefits are clearly contemplated and expected by the language and purpose of the relevant authority, it is not intended that such tax benefits be disallowed if the only reason for such disallowance is that the transaction fails the economic substance doctrine as defined in this proposal.

for the transaction must bear a reasonable relationship to the taxpayer's normal business operations or investment activities.<sup>15</sup>

In determining whether a taxpayer has a substantial non-tax business purpose, an objective of achieving a favorable accounting treatment for financial reporting purposes will not be treated as having a substantial non-tax purpose.<sup>16</sup> Furthermore, a transaction that is expected to increase financial accounting income as a result of generating tax deductions or losses without a corresponding financial accounting charge (i.e., a permanent book-tax difference)<sup>17</sup> should not be considered to have a substantial non-tax purpose unless a substantial non-tax purpose exists apart from the financial accounting benefits.<sup>18</sup>

By requiring that a transaction be a "reasonable means" of accomplishing its non-tax purpose, the proposal broadens the ability of the courts to bifurcate a transaction in which independent activities with non-tax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow the tax benefits of the overall transaction.

---

<sup>15</sup> See, Martin McMahon Jr., *Economic Substance, Purposive Activity, and Corporate Tax Shelters*, 94 Tax Notes 1017, 1023 (Feb. 25, 2002) (advocates "confining the most rigorous application of business purpose, economic substance, and purposive activity tests to transactions outside the ordinary course of the taxpayer's business -- those transactions that do not appear to contribute to any business activity or objective that the taxpayer may have had apart from tax planning but are merely loss generators."); Mark P. Gergen, *The Common Knowledge of Tax Abuse*, 54 SMU L. Rev. 131, 140 (Winter 2001) ("The message is that you can pick up tax gold if you find it in the street while going about your business, but you cannot go hunting for it.").

<sup>16</sup> However, if the tax benefits are clearly contemplated and expected by the language and purpose of the relevant authority, such tax benefits should not be disallowed solely because the transaction results in a favorable accounting treatment. An example is the repealed foreign sales corporation rules.

<sup>17</sup> This includes tax deductions or losses that are anticipated to be recognized in a period subsequent to the period the financial accounting benefit is recognized. For example, FAS 109 in some cases permits the recognition of financial accounting benefits prior to the period in which the tax benefits are recognized for income tax purposes.

<sup>18</sup> Claiming that a financial accounting benefit constitutes a substantial non-tax purpose fails to consider the origin of the accounting benefit (i.e., reduction of taxes) and significantly diminishes the purpose for having a substantial non-tax purpose requirement. See, e.g., *American Electric Power, Inc. v. U.S.*, 136 F. Supp. 2d 762, 791-92 (S.D. Ohio, 2001) ("AEP's intended use of the cash flows generated by the [corporate-owned life insurance] plan is irrelevant to the subjective prong of the economic substance analysis. If a legitimate business purpose for the use of the tax savings 'were sufficient to breathe substance into a transaction whose only purpose was to reduce taxes, [then] every sham tax-shelter device might succeed,'" citing *Winn-Dixie v. Commissioner*, 113 T.C. 254, 287 (1999)).

## **Profit potential**

Under the proposal, a taxpayer may rely on factors other than profit potential to demonstrate that a transaction results in a meaningful change in the taxpayer's economic position; the proposal merely sets forth a minimum threshold of profit potential if that test is relied on to demonstrate a meaningful change in economic position. If a taxpayer relies on a profit potential, however, the present value of the reasonably expected pre-tax profit must be substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.<sup>19</sup> Moreover, the profit potential must exceed a risk-free rate of return. In addition, in determining pre-tax profit, fees and other transaction expenses and foreign taxes are treated as expenses.

A lessor of tangible property subject to a qualified lease shall be considered to have satisfied the profit test with respect to the leased property. For this purpose, a 'qualified lease' is a lease that satisfies the factors for advance ruling purposes as provided by the Treasury Department.<sup>20</sup> In applying the profit test to the lessor of tangible property, certain deductions and other applicable tax credits (such as the rehabilitation tax credit and the low income housing tax credit) are not taken into account in measuring tax benefits. Thus, a traditional leveraged lease is not affected by the proposal to the extent it meets the present law standards.

## **Transactions with tax-indifferent parties**

The proposal also provides special rules for transactions with tax-indifferent parties. For this purpose, a tax-indifferent party means any person or entity not subject to Federal income tax, or any person to whom an item would have no substantial impact on its income tax liability. Under these rules, the form of a financing transaction will not be respected if the present value of the tax deductions to be claimed is substantially in excess of the present value of the anticipated economic returns to the lender. Also, the form of a transaction with a tax-indifferent party will not be respected if it results in an allocation of income or gain to the tax-indifferent party in excess of the tax-indifferent party's economic gain or income or if the transaction results in the shifting of basis on account of overstating the income or gain of the tax-indifferent party.

## **Other rules**

The Secretary may prescribe regulations which provide (1) exemptions from the application of this proposal, and (2) other rules as may be necessary or appropriate to carry out the purposes of the proposal.

---

<sup>19</sup> Thus, a "reasonable possibility of profit" will not be sufficient to establish that a transaction has economic substance.

<sup>20</sup> See Rev. Proc. 2001-28, 2001-19 I.R.B. 1156 which provides guidelines that must be present for a lease to be eligible for advance ruling purposes. It is intended that a lease that satisfies Treasury Department guidelines for advance ruling purposes would be treated as a qualified lease.

No inference is intended as to the proper application of the economic substance doctrine under present law. In addition, except with respect to the economic substance doctrine, the proposal shall not be construed as altering or supplanting any other common law doctrine (including the sham transaction doctrine), and this proposal shall be construed as being additive to any such other doctrine.

### **Effective Date**

The proposal applies to transactions entered into after the date of enactment.

## **2. Penalty for failure to disclose reportable transactions**

### **Present Law**

Regulations under section 6011 require a taxpayer to disclose with its tax return certain information with respect to each “reportable transaction” in which the taxpayer participates.<sup>21</sup>

There are six categories of reportable transactions. The first category is any transaction that is the same as (or substantially similar to)<sup>22</sup> a transaction that is specified by the Treasury Department as a tax avoidance transaction whose tax benefits are subject to disallowance under present law (referred to as a “listed transaction”).<sup>23</sup>

The second category is any transaction that is offered under conditions of confidentiality. In general, if a taxpayer’s disclosure of the structure or tax aspects of the transaction is limited in any way by an express or implied understanding or agreement with or for the benefit of any person who makes or provides a statement, oral or written, as to the potential tax consequences that may result from the transaction, it is considered offered under conditions of confidentiality (whether or not the understanding is legally binding).<sup>24</sup>

---

<sup>21</sup> On February 27, 2003, the Treasury Department and the IRS released final regulations regarding the disclosure of reportable transactions. In general, the regulations are effective for transactions entered into on or after February 28, 2003.

The discussion of present law refers to the new regulations. The rules that apply with respect to transactions entered into on or before February 28, 2003, are contained in Treas. Reg. sec. 1.6011-4T in effect on the date the transaction was entered into.

<sup>22</sup> The regulations clarify that the term “substantially similar” includes any transaction that is expected to obtain the same or similar types of tax consequences and that is either factually similar or based on the same or similar tax strategy. Further, the term must be broadly construed in favor of disclosure. Treas. Reg. sec. 1-6011-4(c)(4).

<sup>23</sup> Treas. Reg. sec. 1.6011-4(b)(2).

<sup>24</sup> Treas. Reg. sec. 1.6011-4(b)(3).

The third category of reportable transactions is any transaction for which (1) the taxpayer has the right to a full or partial refund of fees if the intended tax consequences from the transaction are not sustained or, (2) the fees are contingent on the intended tax consequences from the transaction being sustained.<sup>25</sup>

The fourth category of reportable transactions relates to any transaction resulting in a taxpayer claiming a loss (under section 165) of at least (1) \$10 million in any single year or \$20 million in any combination of years by a corporate taxpayer or a partnership with only corporate partners; (2) \$2 million in any single year or \$4 million in any combination of years by all other partnerships, S corporations, trusts, and individuals; or (3) \$50,000 in any single year for individuals or trusts if the loss arises with respect to foreign currency translation losses.<sup>26</sup>

The fifth category of reportable transactions refers to any transaction done by certain taxpayers<sup>27</sup> in which the tax treatment of the transaction differs (or is expected to differ) by more than \$10 million from its treatment for book purposes (using generally accepted accounting principles) in any year.<sup>28</sup>

The final category of reportable transactions is any transaction that results in a tax credit exceeding \$250,000 (including a foreign tax credit) if the taxpayer holds the underlying asset for less than 45 days.<sup>29</sup>

Under present law, there is no specific penalty for failing to disclose a reportable transaction; however, such a failure may jeopardize a taxpayer's ability to claim that any income tax understatement attributable to such undisclosed transaction is due to reasonable cause, and that the taxpayer acted in good faith.<sup>30</sup>

---

<sup>25</sup> Treas. Reg. sec. 1.6011-4(b)(4).

<sup>26</sup> Treas. Reg. sec. 1.6011-4(b)(5). IRS Rev. Proc. 2003-24, 2003-11 I.R.B. 599, exempts certain types of losses from this reportable transaction category.

<sup>27</sup> The significant book-tax category applies only to taxpayers that are reporting companies under the Securities Exchange Act of 1934 or business entities that have \$250 million or more in gross assets.

<sup>28</sup> Treas. Reg. sec. 1.6011-4(b)(6). IRS Rev. Proc. 2003-25, 2003-11 I.R.B. 601, exempts certain types of transactions from this reportable transaction category.

<sup>29</sup> Treas. Reg. sec. 1.6011-4(b)(7).

<sup>30</sup> Section 6664(c) provides that a taxpayer can avoid the imposition of a section 6662 accuracy-related penalty in cases where the taxpayer can demonstrate that there was reasonable cause for the underpayment and that the taxpayer acted in good faith. On December 31, 2002, the Treasury Department and IRS issued proposed regulations under sections 6662 and 6664 (REG-126016-01) that limit the defenses available to the imposition of an accuracy-related penalty in connection with a reportable transaction when the transaction is not disclosed.

## **Description of Proposal**

### **In general**

The proposal creates a new penalty for any person who fails to include with any return or statement any required information with respect to a reportable transaction. The new penalty applies without regard to whether the transaction ultimately results in an understatement of tax, and applies in addition to any accuracy-related penalty that may be imposed.

### **Transactions to be disclosed**

The proposal does not define the terms “listed transaction”<sup>31</sup> or “reportable transaction,” nor does the proposal explain the type of information that must be disclosed in order to avoid the imposition of a penalty. Rather, the proposal authorizes the Treasury Department to define a “listed transaction” and a “reportable transaction” under section 6011.

### **Penalty rate**

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

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

---

<sup>31</sup> The proposal states that, except as provided in regulations, a listed transaction means a reportable transaction, which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011. For this purpose, it is expected that the definition of “substantially similar” will be the definition used in Treas. Reg. sec. 1.6011-4(c)(4). However, the Secretary may modify this definition (as well as the definitions of “listed transaction” and “reportable transactions”) as appropriate.



A public entity that is required to pay a penalty for failing to disclose a listed transaction (or is subject to an understatement penalty attributable to a non-disclosed listed transaction, a non-disclosed reportable avoidance transaction,<sup>32</sup> or a transaction that lacks economic substance) must disclose the imposition of the penalty in reports to the Securities and Exchange Commission for such period as the Secretary shall specify. The proposal applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear, and treats any failure to disclose a transaction in such reports as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the Securities and Exchange Commission once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).

### **Effective Date**

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

### **3. Modifications to the accuracy-related penalties for listed transactions and reportable transactions having a significant tax avoidance purpose**

#### **Present Law**

The accuracy-related penalty applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or \$5,000 (\$10,000 in the case of corporations), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.<sup>33</sup> The amount of any understatement generally is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.<sup>34</sup>

Special rules apply with respect to tax shelters.<sup>35</sup> For understatements by non-corporate taxpayers attributable to tax shelters, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for the position, the taxpayer reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters.

---

<sup>32</sup> A reportable avoidance transaction is a reportable transaction with a significant tax avoidance purpose.

<sup>33</sup> Sec. 6662.

<sup>34</sup> Sec. 6662(d)(2)(B).

<sup>35</sup> Sec. 6662(d)(2)(C).

The understatement penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was “reasonable cause” for the underpayment and that the taxpayer acted in good faith.<sup>36</sup> The relevant regulations provide that reasonable cause exists where the taxpayer “reasonably relies in good faith on an opinion based on a professional tax advisor’s analysis of the pertinent facts and authorities [that] . . . unambiguously concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged” by the IRS.<sup>37</sup>

## **Description of Proposal**

### **In general**

The proposal modifies the present-law accuracy related penalty by replacing the rules applicable to tax shelters with a new accuracy-related penalty that applies to listed transactions and reportable transactions with a significant tax avoidance purpose (hereinafter referred to as a “reportable avoidance transaction”).<sup>38</sup> The penalty rate and defenses available to avoid the penalty vary depending on whether the transaction was adequately disclosed.

#### **Disclosed transactions**

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

#### **Undisclosed transactions**

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

In addition, a public entity that is required to pay the 30 percent penalty must disclose the imposition of the penalty in reports to the SEC for such periods as the Secretary shall specify. The disclosure to the SEC applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear, and any failure to disclose such penalty in the reports is treated as a failure to disclose a listed transaction. A

---

<sup>36</sup> Sec. 6664(c).

<sup>37</sup> Treas. Reg. sec. 1.6662-4(g)(4)(i)(B); Treas. Reg. sec. 1.6664-4(c).

<sup>38</sup> The terms “reportable transaction” and “listed transaction” have the same meanings as used for purposes of the penalty for failing to disclose reportable transactions.

taxpayer must disclose a penalty in reports to the SEC once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).

Once the 30 percent penalty has been included in the Revenue Agent Report, the penalty cannot be compromised for purposes of a settlement without approval of the Commissioner personally or the head of the Office of Tax Shelter Analysis. Furthermore, the IRS is required to submit an annual report to Congress summarizing the application of this penalty and providing a description of each penalty compromised under this proposal and the reasons for the compromise.

### **Determination of the understatement amount**

The penalty is applied to the amount of any understatement attributable to the listed or reportable avoidance transaction without regard to other items on the tax return. For purposes of this proposal, the amount of the understatement is determined as the sum of (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return)<sup>39</sup>, and (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item.

Except as provided in regulations, a taxpayer's treatment of an item shall not take into account any amendment or supplement to a return if the amendment or supplement is filed after the earlier of when the taxpayer is first contacted regarding an examination of the return or such other date as specified by the Secretary.

### **Strengthened reasonable cause exception**

A penalty is not imposed under the proposal with respect to any portion of an understatement if it shown that there was reasonable cause for such portion and the taxpayer acted in good faith. Such a showing requires (1) adequate disclosure of the facts affecting the transaction in accordance with the regulations under section 6011,<sup>40</sup> (2) that there is or was substantial authority for such treatment, and (3) that the taxpayer reasonably believed that such treatment was more likely than not the proper treatment. For this purpose, a taxpayer will be treated as having a reasonable belief with respect to the tax treatment of an item only if such belief (1) is based on the facts and law that exist at the time the tax return (that includes the item) is filed, and (2) relates solely to the taxpayer's chances of success on the merits and does not take into account the possibility that (a) a return will not be audited, (b) the treatment will not be raised on audit, or (c) the treatment will be resolved through settlement if raised.

---

<sup>39</sup> For this purpose, any reduction in the excess of deductions allowed for the taxable year over gross income for such year, and any reduction in the amount of capital losses which would (without regard to section 1211) be allowed for such year, shall be treated as an increase in taxable income.

<sup>40</sup> See the previous discussion regarding the penalty for failing to disclose a reportable transaction.

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

#### Disqualified tax advisor

A disqualified tax advisor is any advisor who (1) is a material advisor<sup>41</sup> and who participates in the organization, management, promotion or sale of the transaction or is related (within the meaning of section 267 or 707) to any person who so participates, (2) is compensated directly or indirectly<sup>42</sup> by a material advisor with respect to the transaction, (3) has a fee arrangement with respect to the transaction that is contingent on all or part of the intended tax benefits from the transaction being sustained, or (4) as determined under regulations prescribed by the Secretary, has a continuing financial interest with respect to the transaction.

A material advisor is considered as participating in the “organization” of a transaction if the advisor performs acts relating to the development of the transaction. This may include, for example, preparing documents (1) establishing a structure used in connection with the transaction (such as a partnership agreement), (2) describing the transaction (such as an offering memorandum or other statement describing the transaction), or (3) relating to the registration of the transaction with any federal, state or local government body.<sup>43</sup> Participation in the “management” of a transaction means involvement in the decision-making process regarding any business activity with respect to the transaction. Participation in the “promotion or sale” of a transaction means involvement in the marketing or solicitation of the transaction to others. Thus, an advisor who provides information about the transaction to a potential participant is involved

---

<sup>41</sup> The term “material advisor” (defined below in connection with the new information filing requirements for material advisors) means any person who provides any material aid, assistance, or advice with respect to organizing, promoting, selling, implementing, or carrying out any reportable transaction, and who derives gross income in excess of \$50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons (\$250,000 in any other case).

<sup>42</sup> This situation could arise, for example, when an advisor has an arrangement or understanding (oral or written) with an organizer, manager, or promoter of a reportable transaction that such party will recommend or refer potential participants to the advisor for an opinion regarding the tax treatment of the transaction.

<sup>43</sup> An advisor should not be treated as participating in the organization of a transaction if the advisor’s only involvement with respect to the organization of the transaction is the rendering of an opinion regarding the tax consequences of such transaction. However, such an advisor may be a “disqualified tax advisor” with respect to the transaction if the advisor participates in the management, promotion or sale of the transaction (or if the advisor is compensated by a material advisor, has a fee arrangement that is contingent on the tax benefits of the transaction, or as determined by the Secretary, has a continuing financial interest with respect to the transaction).

in the promotion or sale of a transaction, as is any advisor who recommends the transaction to a potential participant.

#### Disqualified opinion

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

#### Coordination with other penalties

Any understatement upon which a penalty is imposed under this proposal is not subject to the accuracy-related penalty under section 6662. However, such understatement is included for purposes of determining whether any understatement (as defined in sec. 6662(d)(2)) is a substantial understatement as defined under section 6662(d)(1).

The penalty imposed under this proposal shall not apply to any portion of an understatement to which a fraud penalty is applied under section 6663.

#### Effective Date

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

### **4. Penalty for understatements from transactions lacking economic substance**

#### Present Law

An accuracy-related penalty applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or \$5,000 (\$10,000 in the case of corporations), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.<sup>44</sup> The amount of any understatement is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.

Special rules apply with respect to tax shelters.<sup>45</sup> For understatements by non-corporate taxpayers attributable to tax shelters, the penalty may be avoided only if the taxpayer establishes

---

<sup>44</sup> Sec. 6662.

<sup>45</sup> Sec. 6662(d)(2)(C).

that, in addition to having substantial authority for the position, the taxpayer reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters.

The penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was “reasonable cause” for the underpayment and that the taxpayer acted in good faith.<sup>46</sup> The relevant regulations provide that reasonable cause exists where the taxpayer “reasonably relies in good faith on an opinion based on a professional tax advisor’s analysis of the pertinent facts and authorities [that] . . . unambiguously concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged” by the IRS.<sup>47</sup>

### **Description of Proposal**

The proposal imposes a penalty for an understatement attributable to any transaction that lacks economic substance (referred to in the statute as a “non-economic substance transaction understatement”).<sup>48</sup> The penalty rate is 40 percent (reduced to 20 percent if the taxpayer adequately discloses the relevant facts in accordance with regulations prescribed under section 6011). No exceptions (including the reasonable cause or rescission rules) to the penalty would be available under the proposal (i.e., the penalty is a strict-liability penalty).

A “non-economic substance transaction” means any transaction if (1) the transaction lacks economic substance (as defined in the earlier proposal regarding the economic substance doctrine),<sup>49</sup> (2) the transaction was not respected under the rules relating to transactions with tax-indifferent parties (as described in the earlier proposal regarding the economic substance doctrine),<sup>50</sup> or (3) any similar rule of law. For this purpose, a similar rule of law would include, for example, an understatement attributable to a transaction that is determined to be a sham transaction.

For purposes of this proposal, the calculation of an “understatement” is made in the same manner as in the separate proposal relating to accuracy-related penalties for listed and reportable

---

<sup>46</sup> Sec. 6664(c).

<sup>47</sup> Treas. Reg. sec. 1.6662-4(g)(4)(i)(B); Treas. Reg. sec. 1.6664-4(c).

<sup>48</sup> Thus, unlike the new accuracy-related penalty under section 6662A (which applies only to listed and reportable avoidance transactions), the new penalty under this proposal applies to any transaction that lacks economic substance.

<sup>49</sup> The proposal provides that a transaction has economic substance only if: (1) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position, and (2) the transaction has a substantial non-tax purpose for entering into such transaction and is a reasonable means of accomplishing such purpose.

<sup>50</sup> The proposal provides that the form of a transaction that involves a tax-indifferent party will not be respected in certain circumstances.

avoidance transactions (new sec. 6662A). Thus, the amount of the understatement under this proposal would be determined as the sum of (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return),<sup>51</sup> and (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item. In essence, the penalty will apply to the amount of any understatement attributable solely to a non-economic substance transaction.

Except as provided in regulations, the taxpayer's treatment of an item will not take into account any amendment or supplement to a return if the amendment or supplement is filed after the earlier of the date the taxpayer is first contacted regarding an examination of the return or such other date as specified by the Secretary.

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

Once a penalty (regardless of whether the transaction was disclosed) has been included in the Revenue Agent Report, the penalty cannot be compromised for purposes of a settlement without approval of the Commissioner personally or the head of the Office of Tax Shelter Analysis. Furthermore, the IRS is required to submit an annual report to Congress summarizing the application of this penalty and providing a description of each penalty compromised under this proposal and the reasons for the compromise.

Any understatement to which a penalty is imposed under this proposal will not be subject to the accuracy-related penalty under section 6662 or under new 6662A (accuracy-related penalties for listed and reportable avoidance transactions). However, an understatement under this proposal would be taken into account for purposes of determining whether any understatement (as defined in sec. 6662(d)(2)) is a substantial understatement as defined under section 6662(d)(1). The penalty imposed under this proposal will not apply to any portion of an understatement to which a fraud penalty is applied under section 6663.

### **Effective Date**

The proposal applies to transactions after the date of enactment.

---

<sup>51</sup> For this purpose, any reduction in the excess of deductions allowed for the taxable year over gross income for such year, and any reduction in the amount of capital losses that would (without regard to section 1211) be allowed for such year, would be treated as an increase in taxable income.

## **5. Modifications to the substantial understatement penalty**

### **Present Law**

#### **Definition of substantial understatement**

An accuracy-related penalty equal to 20 percent applies to any substantial understatement of tax. A “substantial understatement” exists if the correct income tax liability for a taxable year exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or \$5,000 (\$10,000 in the case of most corporations).<sup>52</sup>

#### **Reduction of understatement for certain positions**

For purposes of determining whether a substantial understatement penalty applies, the amount of any understatement generally is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.<sup>53</sup>

The Secretary is required to publish annually in the Federal Register a list of positions for which the Secretary believes there is not substantial authority and which affect a significant number of taxpayers.<sup>54</sup>

### **Description of Proposal**

#### **Definition of substantial understatement**

The proposal modifies the definition of “substantial” for corporate taxpayers. Under the proposal, a corporate taxpayer has a substantial understatement if the amount of the understatement for the taxable year exceeds the lesser of (1) 10 percent of the tax required to be shown on the return for the taxable year (or, if greater, \$10,000), or (2) \$10 million.

#### **Reduction of understatement for certain positions**

The proposal elevates the standard that a taxpayer must satisfy in order to reduce the amount of an understatement for undisclosed items. With respect to the treatment of an item whose facts are not adequately disclosed, a resulting understatement is reduced only if the taxpayer had a reasonable belief that the tax treatment was more likely than not the proper treatment. The proposal also authorizes (but does not require) the Secretary to publish a list of positions for which it believes there is not substantial authority or there is no reasonable belief that the tax treatment is more likely than not the proper treatment (without regard to whether

---

<sup>52</sup> Sec. 6662(a) and (d)(1)(A).

<sup>53</sup> Sec. 6662(d)(2)(B).

<sup>54</sup> Sec. 6662(d)(2)(D).



such positions affect a significant number of taxpayers). The list shall be published in the Federal Register or the Internal Revenue Bulletin.

#### **Effective Date**

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

### **6. Tax shelter exception to confidentiality privileges relating to taxpayer communications**

#### **Present Law**

In general, a common law privilege of confidentiality exists for communications between an attorney and client with respect to the legal advice the attorney gives the client. The Code provides that, with respect to tax advice, the same common law protections of confidentiality that apply to a communication between a taxpayer and an attorney also apply to a communication between a taxpayer and a federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney. This rule is inapplicable to communications regarding corporate tax shelters.

#### **Description of Proposal**

The proposal modifies the rule relating to corporate tax shelters by making it applicable to all tax shelters, whether entered into by corporations, individuals, partnerships, tax-exempt entities, or any other entity. Accordingly, communications with respect to tax shelters are not subject to the confidentiality proposal of the Code that otherwise applies to a communication between a taxpayer and a federally authorized tax practitioner.

#### **Effective Date**

The proposal is effective with respect to communications made on or after the date of enactment.

## 7. Disclosure of reportable transactions by material advisors

### Present Law

#### Registration of tax shelter arrangements

An organizer of a tax shelter is required to register the shelter with the Secretary not later than the day on which the shelter is first offered for sale.<sup>55</sup> A “tax shelter” means any investment with respect to which the tax shelter ratio<sup>56</sup> for any investor as of the close of any of the first five years ending after the investment is offered for sale may be greater than two to one and which is: (1) required to be registered under Federal or State securities laws, (2) sold pursuant to an exemption from registration requiring the filing of a notice with a Federal or State securities agency, or (3) a substantial investment (greater than \$250,000 and at least five investors).<sup>57</sup>

Other promoted arrangements are treated as tax shelters for purposes of the registration requirement if: (1) a significant purpose of the arrangement is the avoidance or evasion of Federal income tax by a corporate participant; (2) the arrangement is offered under conditions of confidentiality; and (3) the promoter may receive fees in excess of \$100,000 in the aggregate.<sup>58</sup>

In general, a transaction has a “significant purpose of avoiding or evading Federal income tax” if the transaction: (1) is the same as or substantially similar to a “listed transaction,”<sup>59</sup> or (2) is structured to produce tax benefits that constitute an important part of the intended results of the arrangement and the promoter reasonably expects to present the arrangement to more than one taxpayer.<sup>60</sup> Certain exceptions are provided with respect to the second category of transactions.<sup>61</sup>

An arrangement is offered under conditions of confidentiality if: (1) an offeree has an understanding or agreement to limit the disclosure of the transaction or any significant tax

---

<sup>55</sup> Sec. 6111(a).

<sup>56</sup> The tax shelter ratio is, with respect to any year, the ratio that the aggregate amount of the deductions and 350 percent of the credits, which are represented to be potentially allowable to any investor, bears to the investment base (money plus basis of assets contributed) as of the close of the tax year.

<sup>57</sup> Sec. 6111(c).

<sup>58</sup> Sec. 6111(d).

<sup>59</sup> Treas. Reg. sec. 301.6111-2(b)(2).

<sup>60</sup> Treas. Reg. sec. 301.6111-2(b)(3).

<sup>61</sup> Treas. Reg. sec. 301.6111-2(b)(4).

features of the transaction; or (2) the promoter knows, or has reason to know that the offeree's use or disclosure of information relating to the transaction is limited in any other manner.<sup>62</sup>

### **Failure to register tax shelter**

The penalty for failing to timely register a tax shelter (or for filing false or incomplete information with respect to the tax shelter registration) generally is the greater of one percent of the aggregate amount invested in the shelter or \$500.<sup>63</sup> However, if the tax shelter involves an arrangement offered to a corporation under conditions of confidentiality, the penalty is the greater of \$10,000 or 50 percent of the fees payable to any promoter with respect to offerings prior to the date of late registration. Intentional disregard of the requirement to register increases the penalty to 75 percent of the applicable fees.

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

### **Description of Proposal**

#### **Disclosure of reportable transactions by material advisors**

The proposal repeals the present law rules with respect to registration of tax shelters. Instead, the proposal requires each material advisor with respect to any reportable transaction (including any listed transaction)<sup>64</sup> to timely file an information return with the Secretary (in such form and manner as the Secretary may prescribe). The return must be filed on such date as specified by the Secretary.

The information return will include (1) information identifying and describing the transaction, (2) information describing any potential tax benefits expected to result from the transaction, and (3) such other information as the Secretary may prescribe. It is expected that the Secretary may seek from the material advisor the same type of information that the Secretary may request from a taxpayer in connection with a reportable transaction.<sup>65</sup>

---

<sup>62</sup> The regulations provide that the determination of whether an arrangement is offered under conditions of confidentiality is based on all the facts and circumstances surrounding the offer. If an offeree's disclosure of the structure or tax aspects of the transaction are limited in any way by an express or implied understanding or agreement with or for the benefit of a tax shelter promoter, an offer is considered made under conditions of confidentiality, whether or not such understanding or agreement is legally binding. Treas. Reg. sec. 301.6111-2(c)(1).

<sup>63</sup> Sec. 6707.

<sup>64</sup> The terms "reportable transaction" and "listed transaction" have the same meaning as previously described in connection with the taxpayer-related proposals.

<sup>65</sup> See the previous discussion regarding the disclosure requirements under new section 6707A.

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

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

### **Penalty for failing to furnish information regarding reportable transactions**

The proposal repeals the present law penalty for failure to register tax shelters. Instead, the proposal imposes a penalty on any material advisor who fails to file an information return, or who files a false or incomplete information return, with respect to a reportable transaction (including a listed transaction).<sup>66</sup> The amount of the penalty is \$50,000. If the penalty is with respect to a listed transaction, the amount of the penalty is increased to the greater of (1) \$200,000, or (2) 50 percent of the gross income of such person with respect to aid, assistance, or advice which is provided with respect to the transaction before the date the information return that includes the transaction is filed. Intentional disregard by a material advisor of the requirement to disclose a listed transaction increases the penalty to 75 percent of the gross income.

The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the penalty can be rescinded (or abated) only in exceptional circumstances.<sup>67</sup> All or part of the penalty may be rescinded only if: (1) the material advisor on whom the penalty is imposed has a history of complying with the Federal tax laws, (2) it is shown that the violation is due to an unintentional mistake of fact, (3) imposing the penalty would be against equity and good conscience, and (4) rescinding the penalty would promote compliance with the tax laws and effective tax administration. The authority to rescind the penalty can only be exercised by the Commissioner personally or the head of the Office of Tax Shelter Analysis; this authority to rescind cannot otherwise be delegated by the Commissioner. Thus, the penalty cannot be rescinded by a revenue agent, an Appeals officer, or other IRS personnel. The decision to rescind a penalty must be accompanied by a record describing the facts and reasons for the action and the amount rescinded. There will be no right to appeal a refusal to rescind a penalty. The IRS also is required to submit an annual report to Congress summarizing the application of the

---

<sup>66</sup> The terms “reportable transaction” and “listed transaction” have the same meaning as previously described in connection with the taxpayer-related proposals.

<sup>67</sup> The Secretary’s present-law authority to postpone certain tax-related deadlines because of Presidentially-declared disasters (sec. 7508A) will also encompass the authority to postpone the reporting deadlines established by the proposal.

disclosure penalties and providing a description of each penalty rescinded under this proposal and the reasons for the rescission.

### **Effective Date**

The proposal requiring disclosure of reportable transactions by material advisors applies to transactions with respect to which material aid, assistance or advice is provided after the date of enactment.

The proposal imposing a penalty for failing to disclose reportable transactions applies to returns the due date for which is after the date of enactment.

## **8. Investor lists and modification of penalty for failure to maintain investor lists**

### **Present Law**

#### **Investor lists**

Any organizer or seller of a potentially abusive tax shelter must maintain a list identifying each person who was sold an interest in any such tax shelter with respect to which registration was required under section 6111 (even though the particular party may not have been subject to confidentiality restrictions).<sup>68</sup> Recently issued regulations under section 6112 contain rules regarding the list maintenance requirements.<sup>69</sup> In general, the regulations apply to transactions that are potentially abusive tax shelters entered into, or acquired after, February 28, 2003.<sup>70</sup>

The regulations provide that a person is an organizer or seller of a potentially abusive tax shelter if the person is a material advisor with respect to that transaction.<sup>71</sup> A material advisor is defined any person who is required to register the transaction under section 6111, or expects to receive a minimum fee of (1) \$250,000 for a transaction that is a potentially abusive tax shelter if all participants are corporations, or (2) \$50,000 for any other transaction that is a potentially abusive tax shelter.<sup>72</sup> For listed transactions (as defined in the regulations under section 6011), the minimum fees are reduced to \$25,000 and \$10,000, respectively.

A potentially abusive tax shelter is any transaction that (1) is required to be registered under section 6111, (2) is a listed transaction (as defined under the regulations under section

---

<sup>68</sup> Sec. 6112.

<sup>69</sup> Treas. Reg. sec. 301-6112-1.

<sup>70</sup> A special rule applies the list maintenance requirements to transactions entered into after February 28, 2000 if the transaction becomes a listed transaction (as defined in Treas. Reg. 1.6011-4) after February 28, 2003.

<sup>71</sup> Treas. Reg. sec. 301.6112-1(c)(1).

<sup>72</sup> Treas. Reg. sec. 301.6112-1(c)(2) and (3).

6011), or (3) any transaction that a potential material advisor, at the time the transaction is entered into, knows is or reasonably expects will become a reportable transaction (as defined under the new regulations under section 6011).<sup>73</sup>

The Secretary is required to prescribe regulations which provide that, in cases in which two or more persons are required to maintain the same list, only one person would be required to maintain the list.<sup>74</sup>

### **Penalty for failing to maintain investor lists**

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

## **Description of Proposal**

### **Investor lists**

Each material advisor<sup>75</sup> with respect to a reportable transaction (including a listed transaction)<sup>76</sup> is required to maintain a list that (1) identifies each person with respect to whom the advisor acted as a material advisor with respect to the reportable transaction, and (2) contains other information as may be required by the Secretary. In addition, the proposal authorizes (but does not require) the Secretary to prescribe regulations which provide that, in cases in which 2 or more persons are required to maintain the same list, only one person would be required to maintain the list.

### **Penalty for failing to maintain investor lists**

The proposal modifies the penalty for failing to maintain the required list by making it a time-sensitive penalty. Thus, a material advisor who is required to maintain an investor list and who fails to make the list available upon written request by the Secretary within 20 business days after the request will be subject to a \$10,000 per day penalty. The penalty applies to a person who fails to maintain a list, maintains an incomplete list, or has in fact maintained a list but does not make the list available to the Secretary. The penalty can be waived if the failure to make the list available is due to reasonable cause.<sup>77</sup>

---

<sup>73</sup> Treas. Reg. sec. 301.6112-1(b).

<sup>74</sup> Sec. 6112(c)(2).

<sup>75</sup> The term “material advisor” has the same meaning as when used in connection with the requirement to file an information return under section 6111.

<sup>76</sup> The terms “reportable transaction” and “listed transaction” have the same meaning as previously described in connection with the taxpayer-related proposals.

<sup>77</sup> In no event will failure to maintain a list be considered reasonable cause for failing to make a list available to the Secretary.

### **Effective Date**

The proposal requiring a material advisor to maintain an investor list applies to transactions with respect to which material aid, assistance or advice is provided after the date of enactment.

The proposal imposing a penalty for failing to maintain investor lists applies to requests made after the date of enactment.

## **9. Actions to enjoin conduct with respect to tax shelters and reportable transactions**

### **Present Law**

The Code authorizes civil action to enjoin any person from promoting abusive tax shelters or aiding or abetting the understatement of tax liability.<sup>78</sup>

### **Description of Proposal**

The proposal expands this rule so that injunctions may also be sought with respect to the requirements relating to the reporting of reportable transactions<sup>79</sup> and the keeping of lists of investors by material advisors.<sup>80</sup> Thus, under the proposal, an injunction may be sought against a material advisor to enjoin the advisor from (1) failing to file an information return with respect to a reportable transaction, or (2) failing to maintain, or to timely furnish upon written request by the Secretary, a list of investors with respect to each reportable transaction.

### **Effective Date**

The proposal is effective on the day after the date of enactment.

## **10. Understatement of taxpayer's liability by income tax return preparer**

### **Present Law**

An income tax return preparer who prepares a return with respect to which there is an understatement of tax that is due to a position for which there was not a realistic possibility of being sustained on its merits and the position was not disclosed (or was frivolous) is liable for a penalty of \$250, provided that the preparer knew or reasonably should have known of the position. An income tax return preparer who prepares a return and engages in specified willful or reckless conduct with respect to preparing such a return is liable for a penalty of \$1,000.

---

<sup>78</sup> Sec. 7408.

<sup>79</sup> Sec. 6707, as amended by other proposals of this bill.

<sup>80</sup> Sec. 6708, as amended by other proposals of this bill.

### **Description of Proposal**

The proposal alters the standards of conduct that must be met to avoid imposition of the first penalty. The proposal replaces the realistic possibility standard with a requirement that there be a reasonable belief that the tax treatment of the position was more likely than not the proper treatment. The proposal also replaces the not frivolous standard with the requirement that there be a reasonable basis for the tax treatment of the position.

In addition, the proposal increases the amount of these penalties. The penalty relating to not having a reasonable belief that the tax treatment was more likely than not the proper tax treatment is increased from \$250 to \$1,000. The penalty relating to willful or reckless conduct is increased from \$1,000 to \$5,000.

### **Effective Date**

The proposal is effective for documents prepared after the date of enactment.

## **11. Penalty for failure to report interests in foreign financial accounts**

### **Present Law**

The Secretary of the Treasury must require citizens, residents, or persons doing business in the United States to keep records and file reports when that person makes a transaction or maintains an account with a foreign financial entity.<sup>81</sup> In general, individuals must fulfill this requirement by answering questions regarding foreign accounts or foreign trusts that are contained in Part III of Schedule B of the IRS Form 1040. Taxpayers who answer “yes” in response to the question regarding foreign accounts must then file Treasury Department Form TD F 90-22.1. This form must be filed with the Department of the Treasury, and not as part of the tax return that is filed with the IRS.

The Secretary of the Treasury may impose a civil penalty on any person who willfully violates this reporting requirement. The civil penalty is the amount of the transaction or the value of the account, up to a maximum of \$100,000; the minimum amount of the penalty is \$25,000.<sup>82</sup> In addition, any person who willfully violates this reporting requirement is subject to a criminal penalty. The criminal penalty is a fine of not more than \$250,000 or imprisonment for not more than five years (or both); if the violation is part of a pattern of illegal activity, the maximum amount of the fine is increased to \$500,000 and the maximum length of imprisonment is increased to 10 years.<sup>83</sup>

---

<sup>81</sup> 31 U.S.C. 5314.

<sup>82</sup> 31 U.S.C. 5321(a)(5).

<sup>83</sup> 31 U.S.C. 5322.



On April 26, 2002, the Secretary of the Treasury submitted to the Congress a report on these reporting requirements.<sup>84</sup> This report, which was statutorily required,<sup>85</sup> studies methods for improving compliance with these reporting requirements. It makes several administrative recommendations, but no legislative recommendations. A further report was required to be submitted by the Secretary of the Treasury to the Congress by October 26, 2002.

### **Description of Proposal**

The proposal adds an additional civil penalty that may be imposed on any person who violates this reporting requirement (without regard to willfulness). This new civil penalty is up to \$5,000. The penalty may be waived if any income from the account was properly reported on the income tax return and there was reasonable cause for the failure to report.

### **Effective Date**

The proposal is effective with respect to failures to report occurring on or after the date of enactment.

## **12. Frivolous tax returns and submissions**

### **Present Law**

The Code provides that an individual who files a frivolous income tax return is subject to a penalty of \$500 imposed by the IRS (sec. 6702). The Code also permits the Tax Court<sup>86</sup> to impose a penalty of up to \$25,000 if a taxpayer has instituted or maintained proceedings primarily for delay or if the taxpayer's position in the proceeding is frivolous or groundless (sec. 6673(a)).

### **Description of Proposal**

The proposal modifies the IRS-imposed penalty by increasing the amount of the penalty to up to \$5,000 and by applying it to all taxpayers and to all types of Federal taxes.

The proposal also modifies present law with respect to certain submissions that raise frivolous arguments or that are intended to delay or impede tax administration. The submissions to which this proposal applies are requests for a collection due process hearing, installment agreements, offers-in-compromise, and taxpayer assistance orders. First, the proposal permits

---

<sup>84</sup> *A Report to Congress in Accordance with Sec. 361(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001*, April 26, 2002.

<sup>85</sup> Sec. 361(b) of the USA PATRIOT Act of 2001 (Pub. L. 107-56).

<sup>86</sup> Because in general the Tax Court is the only pre-payment forum available to taxpayers, it deals with most of the frivolous, groundless, or dilatory arguments raised in tax cases.

the IRS to dismiss such requests. Second, the proposal permits the IRS to impose a penalty of up to \$5,000 for such requests, unless the taxpayer withdraws the request after being given an opportunity to do so.

The proposal requires the IRS to publish a list of positions, arguments, requests, and submissions determined to be frivolous for purposes of these proposals.

#### **Effective Date**

The proposal is effective for submissions made and issues raised after the date on which the Secretary first prescribes the required list.

### **13. Penalties on promoters of tax shelters**

#### **Present Law**

A penalty is imposed on any person who organizes, assists in the organization of, or participates in the sale of any interest in, a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if in connection with such activity the person makes or furnishes a qualifying false or fraudulent statement or a gross valuation overstatement.<sup>87</sup> A qualified false or fraudulent statement is any statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter. A “gross valuation overstatement” means any statement as to the value of any property or services if the stated value exceeds 200 percent of the correct valuation, and the value is directly related to the amount of any allowable income tax deduction or credit.

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

#### **Description of Proposal**

The proposal modifies the penalty amount to equal 50 percent of the gross income derived by the person from the activity for which the penalty is imposed. The new penalty rate applies to any activity that involves a statement regarding the tax benefits of participating in a plan or arrangement if the person knows or has reason to know that such statement is false or fraudulent as to any material matter. The enhanced penalty does not apply to a gross valuation overstatement.

#### **Effective Date**

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

---

<sup>87</sup> Sec. 6700.

## **14. Extend statute of limitations for certain undisclosed transactions**

### **Present Law**

In general, the Code requires that taxes be assessed within three years<sup>88</sup> after the date a return is filed.<sup>89</sup> If there has been a substantial omission of items of gross income that total more than 25 percent of the amount of gross income shown on the return, the period during which an assessment must be made is extended to six years.<sup>90</sup> If an assessment is not made within the required time periods, the tax generally cannot be assessed or collected at any future time. Tax may be assessed at any time if the taxpayer files a false or fraudulent return with the intent to evade tax or if the taxpayer does not file a tax return at all.<sup>91</sup>

### **Description of Proposal**

The proposal extends the statute of limitations to six years with respect to the entire tax return<sup>92</sup> if a taxpayer required to disclose a listed transaction<sup>93</sup> fails to do so in the manner required. For example, if a taxpayer entered into a transaction in 2005 that becomes a listed transaction in 2006 and the taxpayer fails to disclose such transaction in the manner required by Treasury regulations, the 2005 tax return will be subject to a six-year statute of limitations.<sup>94</sup>

### **Effective Date**

The proposal is effective for transactions entered into in taxable years beginning after the date of enactment.

## **15. Deny deduction for interest paid to IRS on underpayments involving certain tax-motivated transactions**

---

<sup>88</sup> Sec. 6501(a).

<sup>89</sup> For this purpose, a return that is filed before the date on which it is due is considered to be filed on the required due date (sec. 6501(b)(1)).

<sup>90</sup> Sec. 6501(e).

<sup>91</sup> Sec. 6501(c).

<sup>92</sup> The tax year extended is the tax year the transaction is entered into.

<sup>93</sup> The term “listed transaction” has the same meaning as described in a previous proposal regarding the penalty for failure to disclose reportable transactions.

<sup>94</sup> However, if the Treasury Department lists a transaction in a year subsequent to the year a taxpayer entered into such transaction, and the taxpayer’s tax return for the year the transaction was entered into is closed by the statute of limitations prior to the transaction becoming a listed transaction, this proposal does not re-open the statute of limitations for such year.

### **Present Law**

In general, corporations may deduct interest paid or accrued within a taxable year on indebtedness.<sup>95</sup> Interest on indebtedness to the Federal government attributable to an underpayment of tax generally may be deducted pursuant to this provision.

### **Description of Proposal**

The proposal disallows any deduction for interest paid or accrued within a taxable year on any portion of an underpayment of tax that is attributable to an understatement arising from (1) an undisclosed reportable avoidance transaction, (2) an undisclosed listed transaction, or (3) a transaction that lacks economic substance.<sup>96</sup>

### **Effective Date**

The proposal is effective for underpayments attributable to transactions entered into in taxable years beginning after the date of enactment.

---

<sup>95</sup> Sec. 163(a).

<sup>96</sup> The definitions of these transactions are the same as those previously described in connection with the proposal to modify the accuracy-related penalty for listed and certain reportable transactions and the proposal to impose a penalty on understatements attributable to transactions that lack economic substance.

## B. Other Proposals

### 1. Affirmation of consolidated return regulation authority

#### Present Law

An affiliated group of corporations may elect to file a consolidated return in lieu of separate returns. A condition of electing to file a consolidated return is that all corporations that are members of the consolidated group must consent to all the consolidated return regulations prescribed under section 1502 prior to the last day prescribed by law for filing such return.<sup>97</sup>

Section 1502 states:

The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent the avoidance of such tax liability.<sup>98</sup>

Under this authority, the Treasury Department has issued extensive consolidated return regulations.<sup>99</sup>

In the recent case of *Rite Aid Corp. v. United States*,<sup>100</sup> the Federal Circuit Court of Appeals addressed the application of a particular provision of certain consolidated return loss

---

<sup>97</sup> Sec. 1501.

<sup>98</sup> Sec. 1502.

<sup>99</sup> Regulations issued under the authority of section 1502 are considered to be “legislative” regulations rather than “interpretative” regulations, and as such are usually given greater deference by courts in case of a taxpayer challenge to such a regulation. *See*, S. Rep. No. 960, 70<sup>th</sup> Cong., 1<sup>st</sup> Sess. at 15, describing the consolidated return regulations as “legislative in character”. The Supreme Court has stated that “. . . legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute.” *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 844 (1984) (involving an environmental protection regulation). For examples involving consolidated return regulations, *see, e.g., Wolter Construction Company v. Commissioner*, 634 F.2d 1029 (6<sup>th</sup> Cir. 1980); *Garvey, Inc. v. United States*, 1 Ct. Cl. 108 (1983), *aff’d* 726 F.2d 1569 (Fed. Cir. 1984), *cert. denied* 469 U.S. 823 (1984). *Compare, e.g., Audrey J. Walton v. Commissioner*, 115 T.C. 589 (2000), describing different standards of review. The case did not involve a consolidated return regulation.

<sup>100</sup> 255 F.3d 1357 (Fed. Cir. 2001), *reh’g denied*, 2001 U.S. App. LEXIS 23207 (Fed. Cir. Oct. 3, 2001).

disallowance regulations, and concluded that the provision was invalid.<sup>101</sup> The particular provision, known as the “duplicated loss” provision,<sup>102</sup> would have denied a loss on the sale of stock of a subsidiary by a parent corporation that had filed a consolidated return with the subsidiary, to the extent the subsidiary corporation had assets that had a built-in loss, or had a net operating loss, that could be recognized or used later.<sup>103</sup>

---

<sup>101</sup> Prior to this decision, there had been a few instances involving prior laws in which certain consolidated return regulations were held to be invalid. *See, e.g., American Standard, Inc. v. United States*, 602 F.2d 256 (Ct. Cl. 1979), discussed in the text *infra. see also Union Carbide Corp. v. United States*, 612 F.2d 558 (Ct. Cl. 1979), and *Allied Corporation v. United States*, 685 F. 2d 396 (Ct. Cl. 1982), all three cases involving the allocation of income and loss within a consolidated group for purposes of computation of a deduction allowed under prior law by the Code for Western Hemisphere Trading Corporations. *See also Joseph Weidenhoff v. Commissioner*, 32 T.C. 1222, 1242-1244 (1959), involving the application of certain regulations to the excess profits tax credit allowed under prior law, and concluding that the Commissioner had applied a particular regulation in an arbitrary manner inconsistent with the wording of the regulation and inconsistent with even a consolidated group computation. *Cf. Kanawha Gas & Utilities Co. v. Commissioner*, 214 F.2d 685 (1954), concluding that the substance of a transaction was an acquisition of assets rather than stock. Thus, a regulation governing basis of the assets of consolidated subsidiaries did not apply to the case. *See also General Machinery Corporation v. Commissioner*, 33 B.T.A. 1215 (1936); *Lefcourt Realty Corporation*, 31 B.T.A. 978 (1935); *Helvering v. Morgans, Inc.*, 293 U.S. 121 (1934), interpreting the term “taxable year.”

<sup>102</sup> Treas. Reg. Sec. 1.1502-20(c)(1)(iii).

<sup>103</sup> Treasury Regulation section 1.1502-20, generally imposing certain “loss disallowance” rules on the disposition of subsidiary stock, contained other limitations besides the “duplicated loss” rule that could limit the loss available to the group on a disposition of a subsidiary’s stock. Treasury Regulation section 1.1502-20 as a whole was promulgated in connection with regulations issued under section 337(d), principally in connection with the so-called *General Utilities* repeal of 1986 (referring to the case of *General Utilities & Operating Company v. Helvering*, 296 U.S. 200 (1935)). Such repeal generally required a liquidating corporation, or a corporation acquired in a stock acquisition treated as a sale of assets, to pay corporate level tax on the excess of the value of its assets over the basis. Treasury regulation section 1.1502-20 principally reflected an attempt to prevent corporations filing consolidated returns from offsetting income with a loss on the sale of subsidiary stock. Such a loss could result from the unique upward adjustment of a subsidiary’s stock basis required under the consolidated return regulations for subsidiary income earned in consolidation, an adjustment intended to prevent taxation of both the subsidiary and the parent on the same income or gain. As one example, absent a denial of certain losses on a sale of subsidiary stock, a consolidated group could obtain a loss deduction with respect to subsidiary stock, the basis of which originally reflected the subsidiary’s value at the time of the purchase of the stock, and that had then been adjusted upward on recognition of any built-in income or gain of the subsidiary reflected in that value. The regulations also contained the duplicated loss factor addressed by the court in *Rite Aid*. The preamble to the regulations stated: “it is not administratively feasible to differentiate

The Federal Circuit Court opinion contained language discussing the fact that the regulation produced a result different than the result that would have obtained if the corporations had filed separate returns rather than consolidated returns.<sup>104</sup>

The Federal Circuit Court opinion cited a 1928 Senate Finance Committee Report to legislation that authorized consolidated return regulations, which stated that “many difficult and complicated problems, ... have arisen in the administration of the provisions permitting the filing of consolidated returns” and that the committee “found it necessary to delegate power to the commissioner to prescribe regulations legislative in character covering them.”<sup>105</sup> The Court’s opinion also cited a previous decision of the Court of Claims for the proposition, interpreting this legislative history, that section 1502 grants the Secretary “the power to conform the applicable income tax law of the Code to the special, myriad problems resulting from the filing of consolidated income tax returns;” but that section 1502 “does not authorize the Secretary to choose a method that imposes a tax on income that would not otherwise be taxed.”<sup>106</sup>

---

between loss attributable to built-in gain and duplicated loss.” T.D. 8364, 1991-2 C.B. 43, 46 (Sept. 13, 1991). The government also argued in the *Rite Aid* case that duplicated loss was a separate concern of the regulations. 255 F.3d at 1360.

<sup>104</sup> For example, the court stated: “The duplicated loss factor . . . addresses a situation that arises from the sale of stock regardless of whether corporations file separate or consolidated returns. With I.R.C. secs. 382 and 383, Congress has addressed this situation by limiting the subsidiary’s potential future deduction, not the parent’s loss on the sale of stock under I.R.C. sec. 165.” 255 F.3d 1357, 1360 (Fed. Cir. 2001).

<sup>105</sup> S. Rep. No. 960, 70<sup>th</sup> Cong., 1<sup>st</sup> Sess. 15 (1928). Though not quoted by the court in *Rite Aid*, the same Senate report also indicated that one purpose of the consolidated return authority was to permit treatment of the separate corporations as if they were a single unit, stating “The mere fact that by legal fiction several corporations owned by the same shareholders are separate entities should not obscure the fact that they are in reality one and the same business owned by the same individuals and operated as a unit.” S. Rep. No. 960, 70<sup>th</sup> Cong., 1<sup>st</sup> Sess. 29 (1928).

<sup>106</sup> *American Standard, Inc. v. United States*, 602 F.2d 256, 261 (Ct. Cl. 1979). That case did not involve the question of separate returns as compared to a single return approach. It involved the computation of a Western Hemisphere Trade Corporation (“WHTC”) deduction under prior law (which deduction would have been computed as a percentage of each WHTC’s taxable income if the corporations had filed separate returns), in a case where a consolidated group included several WHTCs as well as other corporations. The question was how to apportion income and losses of the admittedly consolidated WHTCs and how to combine that computation with the rest of the group’s consolidated income or losses. The court noted that the new, changed regulations approach varied from the approach taken to a similar problem involving public utilities within a group and previously allowed for WHTCs. The court objected that the allocation method adopted by the regulation allowed non-WHTC losses to reduce WHTC income. However, the court did not disallow a method that would net WHTC income of one WHTC with losses of another WHTC, a result that would not have occurred under separate

The Federal Circuit Court construed these authorities and applied them to invalidate Treas. Reg. Sec. 1.1502-20(c)(1)(iii), stating that:

The loss realized on the sale of a former subsidiary's assets after the consolidated group sells the subsidiary's stock is not a problem resulting from the filing of consolidated income tax returns. The scenario also arises where a corporate shareholder sells the stock of a non-consolidated subsidiary. The corporate shareholder could realize a loss under I.R.C. sec. 1001, and deduct the loss under I.R.C. sec. 165. The subsidiary could then deduct any losses from a later sale of assets. The duplicated loss factor, therefore, addresses a situation that arises from the sale of stock regardless of whether corporations file separate or consolidated returns. With I.R.C. secs. 382 and 383, Congress has addressed this situation by limiting the subsidiary's potential future deduction, not the parent's loss on the sale of stock under I.R.C. sec. 165.<sup>107</sup>

The Treasury Department has announced that it will not continue to litigate the validity of the duplicated loss provision of the regulations, and has issued interim regulations that permit taxpayers for all years to elect a different treatment, though they may apply the provision for the past if they wish.<sup>108</sup>

### **Description of Proposal**

The proposal confirms that, in exercising its authority under section 1502 to issue consolidated return regulations, the Treasury Department may provide rules treating corporations filing consolidated returns differently from corporations filing separate returns.

Thus, under the statutory authority of section 1502, the Treasury Department is authorized to issue consolidated return regulations utilizing either a single taxpayer or separate taxpayer approach or a combination of the two approaches, as Treasury deems necessary in order that the tax liability of any affiliated group of corporations making a consolidated return, and of each corporation in the group, both during and after the period of affiliation, may be determined and adjusted in such manner as clearly to reflect the income-tax liability and the various factors

---

returns. Nor did the court expressly disallow a different fractional method that would net both income and losses of the WHTCs with those of other corporations in the consolidated group. The court also found that the regulation had been adopted without proper notice.

<sup>107</sup> *Rite Aid*, 255 F.3d at 1360.

<sup>108</sup> *See* Temp. Reg. 1.1502-20T(i)(2). The Treasury Department has also indicated its intention to continue to study all the issues that the original loss disallowance regulations addressed (including issues of furthering single entity principles) and possibly issue different regulations (not including the particular approach of Treas. Reg. Sec. 1.1502-20(c)(1)(iii)) on the issues in the future. *See* Notice 2002-11, 2002-7 I.R.B. 526 (Feb. 19, 2002); T.D. 8984, 67 F.R. 11034 (March 12, 2002); REG-102740-02, 67 F.R. 11070 (March 12, 2002); *see also* Notice 2002-18, 2002-12 I.R.B. 644 (March 25, 2002).



necessary for the determination of such liability, and in order to prevent avoidance of such liability.

*Rite Aid* is thus overruled to the extent it suggests that there is not a problem that can be addressed in consolidated return regulations if application of a particular Code provision on a separate taxpayer basis would produce a result different from single taxpayer principles that may be used for consolidation.

The proposal nevertheless allows the result of the *Rite Aid* case to stand with respect to the type of factual situation presented in the case. That is, the legislation provides for the override of the regulatory provision that took the approach of denying a loss on a deconsolidating disposition of stock of a consolidated subsidiary<sup>109</sup> to the extent the subsidiary had net operating losses or built in losses that could be used later outside the group.<sup>110</sup>

Retaining the result in the *Rite Aid* case with respect to the particular regulation section 1.1502-20(c)(1)(iii) as applied to the factual situation of the case does not in any way prevent or invalidate the various approaches Treasury has announced it will apply or that it intends to consider in lieu of the approach of that regulation, including, for example, the denial of a loss on a stock sale if inside losses of a subsidiary may also be used by the consolidated group, and the possible requirement that inside attributes be adjusted when a subsidiary leaves a group.<sup>111</sup>

#### **Effective Date**

The proposal is effective for all years, whether beginning before, on, or after the date of enactment of the proposal.

No inference is intended that the results following from this proposal are not the same as the results under present law.

---

<sup>109</sup> Treas. Reg. Sec. 1.1502-20(c)(1)(iii).

<sup>110</sup> The proposal is not intended to overrule the current Treasury Department regulations, which allow taxpayers for the past to follow Treasury Regulations Section 1.1502-20(c)(1)(iii), if they choose to do so. Temp. Reg. Sec. 1.1502-20T(i)(2).

<sup>111</sup> See, e.g., Notice 2002-11, 2002-7 I.R.B. 526 (Feb. 19, 2002); T.D. 8984, 67 F.R. 11034 (Mar.12, 2002); REG-102740-02, 67 F.R. 11070 (Mar.12, 2002); see also Notice 2002-18, 2002-12 I.R.B. 644 (Mar. 25, 2002). In exercising its authority under section 1502, the Secretary is also authorized to prescribe rules that protect the purpose of *General Utilities* repeal using presumptions and other simplifying conventions.

## **2. Chief Executive Officer Required To Sign Corporate Income Tax Returns**

### **Present Law**

The Code requires<sup>112</sup> that the income tax return of a corporation must be signed by either the president, the vice-president, the treasurer, the assistant treasurer, the chief accounting officer, or any other officer of the corporation authorized by the corporation to sign the return.

The Code also imposes<sup>113</sup> a criminal penalty on any person who willfully signs any tax return under penalties of perjury that that person does not believe to be true and correct with respect to every material matter at the time of filing. If convicted, the person is guilty of a felony; the Code imposes a fine of not more than \$100,000<sup>114</sup> (\$500,000 in the case of a corporation) or imprisonment of not more than three years, or both, together with the costs of prosecution.

### **Description of Proposal**

The proposal requires that the chief executive officer of a corporation sign that corporation's income tax returns. If the corporation does not have a chief executive officer, the IRS may designate another officer of the corporation; otherwise, no other person is permitted to sign the income tax return of a corporation. It is intended that the IRS issue general guidance, such as a revenue procedure, to (1) address situations when a corporation does not have a chief executive officer, and (2) define who the chief executive officer is, in situations (for example) when the primary official bears a different title or when a corporation has multiple chief executive officers. It is intended that, in every instance, the highest ranking corporate officer (regardless of title) sign the tax return.

The proposal does not apply to the income tax returns of mutual funds;<sup>115</sup> they are required to be signed as under present law.

### **Effective Date**

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

---

<sup>112</sup> Sec. 6062.

<sup>113</sup> Sec. 7206.

<sup>114</sup> Pursuant to 18 U.S.C. 3571, the maximum fine for an individual convicted of a felony is \$250,000.

<sup>115</sup> The proposal does, however, apply to the income tax returns of mutual fund management companies and advisors.

## **C. Enron-Related Tax Shelter Related Provisions**

### **1. Limitation on transfer and importation of built-in losses**

#### **Present Law**

Generally, no gain or loss is recognized when one or more persons transfer property to a corporation in exchange for stock and immediately after the exchange such person or persons control the corporation.<sup>116</sup> The transferor's basis in the stock of the controlled corporation is the same as the basis of the property contributed to the controlled corporation, increased by the amount of any gain (or dividend) recognized by the transferor on the exchange, and reduced by the amount of any money or property received, and by the amount of any loss recognized by the transferor.<sup>117</sup>

The basis of property received by a corporation, whether from domestic or foreign transferors, in a tax-free incorporation, reorganization, or liquidation of a subsidiary corporation is the same as the adjusted basis in the hands of the transferor, adjusted for gain or loss recognized by the transferor.<sup>118</sup>

#### **Description of Proposal**

##### **Importation of built-in losses**

The proposal provides that if a net built-in loss is imported into the U.S. in a tax-free organization or reorganization from persons not subject to U.S. tax, the basis of each property so transferred is its fair market value. A similar rule applies in the case of the tax-free liquidation by a domestic corporation of its foreign subsidiary.

Under the proposal, a net built-in loss is treated as imported into the U.S. if the aggregate adjusted bases of property received by a transferee corporation exceeds the fair market value of the properties transferred. Thus, for example, if in a tax-free incorporation, some properties are received by a corporation from U. S. persons subject to tax, and some properties are received from foreign persons not subject to U.S. tax, this provision applies to limit the adjusted basis of each property received from the foreign persons to the fair market value of the property. In the case of a transfer by a partnership (either domestic or foreign), this provision applies as if the properties had been transferred by each of the partners in proportion to their interests in the partnership.

##### **Limitation on transfer of built-in-losses in section 351 transactions**

---

<sup>116</sup> Sec. 351.

<sup>117</sup> Sec. 358.

<sup>118</sup> Secs. 334(b) and 362(a) and (b).

The proposal provides that if the aggregate adjusted bases of property contributed by a transferor (or by a control group of which the transferor is a member) to a corporation exceed the aggregate fair market value of the property transferred in a tax-free incorporation, the transferee's aggregate basis of the properties is limited to the aggregate fair market value of the transferred property. Under the proposal, any required basis reduction is allocated among the transferred properties in proportion to after which the transferor owns at least 80 percent of the vote and value of the stock of the transferee corporation, any basis reduction required by the proposal is made to the stock received by the transferor and not to the assets transferred.

**Effective Date**

The proposal applies to transactions after February 13, 2003.

## **2. No reduction of basis under section 734 in stock held by partnership in corporate partner**

### **Present Law**

#### **In general**

Generally, a partner and the partnership do not recognize gain or loss on a contribution of property to a partnership.<sup>119</sup> Similarly, a partner and the partnership generally do not recognize gain or loss on the distribution of partnership property.<sup>120</sup> This includes current distributions and distributions in liquidation of a partner's interest.

#### **Basis of property distributed in liquidation**

The basis of property distributed in liquidation of a partner's interest is equal to the partner's tax basis in its partnership interest (reduced by any money distributed in the same transaction).<sup>121</sup> Thus, the partnership's tax basis in the distributed property is adjusted (increased or decreased) to reflect the partner's tax basis in the partnership interest.

#### **Election to adjust basis of partnership property**

When a partnership distributes partnership property, generally, the basis of partnership property is not adjusted to reflect the effects of the distribution or transfer. The partnership is permitted, however, to make an election (referred to as a 754 election) to adjust the basis of partnership property in the case of a distribution of partnership property.<sup>122</sup> The effect of the 754 election is that the partnership adjusts the basis of its remaining property to reflect any change in basis of the distributed property in the hands of the distributee partner resulting from the distribution transaction. Such a change could be a basis increase due to gain recognition, or a basis decrease due to the partner's adjusted basis in its partnership interest exceeding the adjusted basis of the property received. If the 754 election is made, it applies to the taxable year with respect to which such election was filed and all subsequent taxable years.

In the case of a distribution of partnership property to a partner with respect to which the 754 election is in effect, the partnership increases the basis of partnership property by (1) any gain recognized by the distributee partner (2) the excess of the adjusted basis of the distributed property to the partnership immediately before its distribution over the basis of the property to the distributee partner, and decreases the basis of partnership property by (1) any loss recognized by the distributee partner and (2) the excess of the basis of the property to the distributee partner

---

<sup>119</sup> Sec. 721(a).

<sup>120</sup> Sec. 731(a) and (b).

<sup>121</sup> Sec. 732(b).

<sup>122</sup> Sec. 754.

over the adjusted basis of the distributed property to the partnership immediately before the distribution.

The allocation of the increase or decrease in basis of partnership property is made in a manner which has the effect of reducing the difference between the fair market value and the adjusted basis of partnership properties.<sup>123</sup> In addition, the allocation rules require that any increase or decrease in basis be allocated to partnership property of a like character to the property distributed. For this purpose, the two categories of assets are (1) capital assets and depreciable and real property used in the trade or business held for more than one year, and (2) any other property.<sup>124</sup>

### **Description of Proposal**

The proposal provides that in applying the basis allocation rules to a distribution in liquidation of a partner's interest, a partnership is precluded from decreasing the basis of corporate stock of a partner or a related person. Any decrease in basis that, absent the proposal, would have been allocated to the stock is allocated to other partnership assets. If the decrease in basis exceeds the basis of the other partnership assets, then gain is recognized by the partnership in the amount of the excess.

### **Effective Date**

The proposal applies to distributions after February 13, 2003.

---

<sup>123</sup> Sec. 755(a).

<sup>124</sup> Sec. 755(b).

### 3. Repeal of special rules for FASITs

#### Present Law

##### Financial asset securitization investment trusts

In 1996, Congress created a new type of statutory entity called a “financial asset securitization trust” (“FASIT”) that facilitates the securitization of debt obligations such as credit card receivables, home equity loans, and auto loans.<sup>125</sup> A FASIT generally is not taxable; the FASIT’s taxable income or net loss flows through to the owner of the FASIT.

The ownership interest of a FASIT generally is required to be entirely held by a single domestic C corporation. In addition, a FASIT generally may hold only qualified debt obligations, and certain other specified assets, and is subject to certain restrictions on its activities. An entity that qualifies as a FASIT can issue one or more classes of instruments that meet certain specified requirements and treat those instruments as debt for Federal income tax purposes. Instruments issued by a FASIT bearing yields to maturity over five percentage points above the yield to maturity on specified United States government obligations (i.e., “high-yield interests”) must be held, directly or indirectly, only by domestic C corporations that are not exempt from income tax.

##### Qualification as a FASIT

To qualify as a FASIT, an entity must: (1) make an election to be treated as a FASIT for the year of the election and all subsequent years;<sup>126</sup> (2) have assets substantially all of which (including assets that the FASIT is treated as owning because they support regular interests) are specified types called “permitted assets;” (3) have non-ownership interests be certain specified types of debt instruments called “regular interests;” (4) have a single ownership interest which is held by an “eligible holder;” and (5) not qualify as a regulated investment company (“RIC”). Any entity, including a corporation, partnership, or trust may be treated as a FASIT. In addition, a segregated pool of assets may qualify as a FASIT.

An entity ceases qualifying as a FASIT if the entity's owner ceases being an eligible corporation. Loss of FASIT status is treated as if all of the regular interests of the FASIT were retired and then reissued without the application of the rule that deems regular interests of a FASIT to be debt.

##### Permitted assets

---

<sup>125</sup> Sections 860H through 860L.

<sup>126</sup> Once an election to be a FASIT is made, the election applies from the date specified in the election and all subsequent years until the entity ceases to be a FASIT. If an election to be a FASIT is made after the initial year of an entity, all of the assets in the entity at the time of the FASIT election are deemed contributed to the FASIT at that time and, accordingly, any gain (but not loss) on such assets will be recognized at that time.

For an entity or arrangement to qualify as a FASIT, substantially all of its assets must consist of the following “permitted assets”: (1) cash and cash equivalents; (2) certain permitted debt instruments; (3) certain foreclosure property; (4) certain instruments or contracts that represent a hedge or guarantee of debt held or issued by the FASIT; (5) contract rights to acquire permitted debt instruments or hedges; and (6) a regular interest in another FASIT. Permitted assets may be acquired at any time by a FASIT, including any time after its formation.

#### “Regular interests” of a FASIT

“Regular interests” of a FASIT are treated as debt for Federal income tax purposes, regardless of whether instruments with similar terms issued by non-FASITs might be characterized as equity under general tax principles. To be treated as a “regular interest”, an instrument must have fixed terms and must: (1) unconditionally entitle the holder to receive a specified principal amount; (2) pay interest that is based on (a) fixed rates, or (b) except as provided by regulations issued by the Treasury Secretary, variable rates permitted with respect to REMIC interests under section 860G(a)(1)(B)(i); (3) have a term to maturity of no more than 30 years, except as permitted by Treasury regulations; (4) be issued to the public with a premium of not more than 25 percent of its stated principal amount; and (5) have a yield to maturity determined on the date of issue of less than five percentage points above the applicable Federal rate (“AFR”) for the calendar month in which the instrument is issued.

#### Permitted ownership holder

A permitted holder of the ownership interest in a FASIT generally is a non-exempt (i.e., taxable) domestic C corporation, other than a corporation that qualifies as a RIC, REIT, REMIC, or cooperative.

#### Transfers to FASITs

In general, gain (but not loss) is recognized immediately by the owner of the FASIT upon the transfer of assets to a FASIT. Where property is acquired by a FASIT from someone other than the FASIT’s owner (or a person related to the FASIT’s owner), the property is treated as being first acquired by the FASIT’s owner for the FASIT’s cost in acquiring the asset from the non-owner and then transferred by the owner to the FASIT.

Valuation rules. In general, except in the case of debt instruments, the value of FASIT assets is their fair market value. Similarly, in the case of debt instruments that are traded on an established securities market, the market price is used for purposes of determining the amount of gain realized upon contribution of such assets to a FASIT. However, in the case of debt instruments that are not traded on an established securities market, special valuation rules apply for purposes of computing gain on the transfer of such debt instruments to a FASIT. Under these rules, the value of such debt instruments is the sum of the present values of the reasonably expected cash flows from such obligations discounted over the weighted average life of such assets. The discount rate is 120 percent of the AFR, compounded semiannually, or such other rate that the Treasury Secretary shall prescribe by regulations.



### Taxation of a FASIT

A FASIT generally is not subject to tax. Instead, all of the FASIT's assets and liabilities are treated as assets and liabilities of the FASIT's owner and any income, gain, deduction or loss of the FASIT is allocable directly to its owner. Accordingly, income tax rules applicable to a FASIT (e.g., related party rules, sec. 871(h), sec. 165(g)(2)) are to be applied in the same manner as they apply to the FASIT's owner. The taxable income of a FASIT is calculated using an accrual method of accounting. The constant yield method and principles that apply for purposes of determining original issue discount ("OID") accrual on debt obligations whose principal is subject to acceleration apply to all debt obligations held by a FASIT to calculate the FASIT's interest and discount income and premium deductions or adjustments.

### Taxation of holders of FASIT regular interests

In general, a holder of a regular interest is taxed in the same manner as a holder of any other debt instrument, except that the regular interest holder is required to account for income relating to the interest on an accrual method of accounting, regardless of the method of accounting otherwise used by the holder.

### Taxation of holders of FASIT ownership interests

Because all of the assets and liabilities of a FASIT are treated as assets and liabilities of the holder of a FASIT ownership interest, the ownership interest holder takes into account all of the FASIT's income, gain, deduction, or loss in computing its taxable income or net loss for the taxable year. The character of the income to the holder of an ownership interest is the same as its character to the FASIT, except tax-exempt interest is included in the income of the holder as ordinary income.

Although the recognition of losses on assets contributed to the FASIT is not allowed upon contribution of the assets, such losses may be allowed to the FASIT owner upon their disposition by the FASIT. Furthermore, the holder of a FASIT ownership interest is not permitted to offset taxable income from the FASIT ownership interest (including gain or loss from the sale of the ownership interest in the FASIT) with other losses of the holder. In addition, any net operating loss carryover of the FASIT owner shall be computed by disregarding any income arising by reason of a disallowed loss. Where the holder of a FASIT ownership interest is a member of a consolidated group, this rule applies to the consolidated group of corporations of which the holder is a member as if the group were a single taxpayer.

### **Description of Proposal**

The proposal repeals the special rules for FASITs. The proposal provides a transition period for existing FASITs, pursuant to which the repeal of the FASIT rules would not apply to any FASIT in existence on the date of enactment to the extent that regular interests issued by the FASIT prior to such date continue to remain outstanding in accordance with their original terms.

### **Effective Date**

Except as provided by the transition period for existing FASITs, the proposal is effective after February 13, 2003.

#### **4. Expanded disallowance of deduction for interest on convertible debt**

##### **Present Law**

Whether an instrument qualifies for tax purposes as debt or equity is determined under all the facts and circumstances based on principles developed in case law. If an instrument qualifies as equity, the issuer generally does not receive a deduction for dividends paid and the holder generally includes such dividends in income (although corporate holders generally may obtain a dividends-received deduction of at least 70 percent of the amount of the dividend). If an instrument qualifies as debt, the issuer may receive a deduction for accrued interest and the holder generally includes interest in income, subject to certain limitations.

Original issue discount (“OID”) on a debt instrument is the excess of the stated redemption price at maturity over the issue price of the instrument. An issuer of a debt instrument with OID generally accrues and deducts the discount as interest over the life of the instrument even though interest may not be paid until the instrument matures. The holder of such a debt instrument also generally includes the OID in income on an accrual basis.

Under present law, no deduction is allowed for interest or OID on a debt instrument issued by a corporation (or issued by a partnership to the extent of its corporate partners) that is payable in equity of the issuer or a related party (within the meaning of sections 267(b) and 707(b)), including a debt instrument a substantial portion of which is mandatorily convertible or convertible at the issuer's option into equity of the issuer or a related party.<sup>127</sup> In addition, a debt instrument is treated as payable in equity if a substantial portion of the principal or interest is required to be determined, or may be determined at the option of the issuer or related party, by reference to the value of equity of the issuer or related party.<sup>128</sup> A debt instrument also is treated as payable in equity if it is part of an arrangement that is designed to result in the payment of the debt instrument with or by reference to such equity, such as in the case of certain issuances of a forward contract in connection with the issuance of debt, nonrecourse debt that is secured principally by such equity, or certain debt instruments that are paid in, converted to, or determined with reference to the value of equity if it may be so required at the option of the holder or a related party and there is a substantial certainty that option will be exercised.<sup>129</sup>

##### **Description of Proposal**

The proposal expands the present-law disallowance of interest deductions on certain corporate debt that is payable in, or by reference to the value of, equity. Under the proposal, the disallowance includes interest on corporate debt that is payable in, or by reference to the value of, any equity held by the issuer (or any related party) in any other person, without regard to

---

<sup>127</sup> Sec. 163(l), enacted in the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1005(a).

<sup>128</sup> Sec. 163(l)(3)(B).

<sup>129</sup> Sec. 163(l)(3)(C).

whether such equity represents more than a 50-percent ownership interest in such person. However, the proposal does not apply to debt that is issued by an active dealer in securities (or a related party) if the debt is payable in, or by reference to the value of, equity that is held by the securities dealer in its capacity as a dealer in securities.

**Effective Date**

This proposal applies to debt instruments that are issued after February 13, 2003.

## **5. Expanded authority to disallow tax benefits under section 269**

### **Present Law**

Section 269 provides that if a taxpayer acquires, directly or indirectly, control (defined as at least 50 percent of vote or value) of a corporation, and the principal purpose of the acquisition is the evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance that would not otherwise have been available, the Secretary may disallow the such tax benefits.<sup>130</sup> Similarly, if a corporation acquires, directly or indirectly, property of another corporation (not controlled, directly or indirectly, by the acquiring corporation or its stockholders immediately before the acquisition), the basis of such property is determined by reference to the basis in the hands of the transferor corporation, and the principal purpose of the acquisition is the evasion or avoidance of Federal income tax by securing a tax benefit that would not otherwise have been available, the Secretary may disallow such tax benefits.<sup>131</sup>

### **Description of Proposal**

The proposal expands section 269 by repealing (1) the requirement that the acquisition of stock be sufficient to obtain control of the corporation, and (2) the requirement that the acquisition of property be from a corporation not controlled by the acquirer. Thus, under the proposal, section 269 disallows the tax benefits of (1) any acquisition of stock in a corporation,<sup>132</sup> and (2) any acquisition by a corporation of property from a corporation in which the basis of such property is determined by reference to the basis in the hands of the transferor corporation, if the principal purpose of such acquisition is the of evasion or avoidance of Federal income tax.

### **Effective Date**

The proposal applies to stock and property acquired after February 13, 2003.

---

<sup>130</sup> Sec. 269(a)(1).

<sup>131</sup> Sec. 269(a)(2).

<sup>132</sup> In this regard, the proposal applies regardless of whether an acquisition results in an increase in the acquiror's ownership percentage in a corporation or involves the issuance of actual stock certificates or shares by a corporation to the acquiror.

## 6. Modification of CFC-PFIC coordination rules

### Present Law

The United States employs a “worldwide” tax system, under which domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income generally is deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F<sup>133</sup> and the passive foreign investment company rules.<sup>134</sup> A foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income, whether earned directly by the domestic corporation, repatriated as an actual dividend, or included under one of the anti-deferral regimes.<sup>135</sup>

Generally, income earned indirectly by a domestic corporation through a foreign corporation is subject to U.S. tax only when the income is distributed to the domestic corporation, because corporations generally are treated as separate taxable persons for Federal tax purposes. However, this deferral of U.S. tax is limited by anti-deferral regimes that impose current U.S. tax on certain types of income earned by certain corporations, in order to prevent taxpayers from avoiding U.S. tax by shifting passive or other highly mobile income into low-tax jurisdictions. Deferral of U.S. tax is considered appropriate, on the other hand, with respect to most types of active business income earned abroad.

Subpart F,<sup>136</sup> applicable to controlled foreign corporations and their shareholders, is the main anti-deferral regime of relevance to a U.S.-based multinational corporate group. A controlled foreign corporation generally is defined as any foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation’s stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only).<sup>137</sup> Under the subpart F rules, the United States generally taxes the U.S. 10-percent shareholders of a controlled foreign corporation on their pro

---

<sup>133</sup> Secs. 951-964.

<sup>134</sup> Secs. 1291-1298.

<sup>135</sup> Secs. 901, 902, 960, 1291(g).

<sup>136</sup> Secs. 951-964.

<sup>137</sup> Secs. 951(b), 957, 958.

rata shares of certain income of the controlled foreign corporation (referred to as “subpart F income”), without regard to whether the income is distributed to the shareholders.<sup>138</sup>

Subpart F income generally includes passive income and other income that is readily movable from one taxing jurisdiction to another. Subpart F income consists of foreign base company income,<sup>139</sup> insurance income,<sup>140</sup> and certain income relating to international boycotts and other violations of public policy.<sup>141</sup> Foreign base company income consists of foreign personal holding company income, which includes passive income (e.g., dividends, interest, rents, and royalties), as well as a number of categories of non-passive income, including foreign base company sales income, foreign base company services income, foreign base company shipping income and foreign base company oil-related income.<sup>142</sup>

In effect, the United States treats the U.S. 10-percent shareholders of a controlled foreign corporation as having received a current distribution out of the corporation's subpart F income. In addition, the U.S. 10-percent shareholders of a controlled foreign corporation are required to include currently in income for U.S. tax purposes their pro rata shares of the corporation's earnings invested in U.S. property.<sup>143</sup>

The Tax Reform Act of 1986 established an additional anti-deferral regime, for passive foreign investment companies. A passive foreign investment company generally is defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or 50 percent or more of its assets consists of assets that produce, or are held for the production of, passive income.<sup>144</sup> Alternative sets of income inclusion rules apply to U.S. persons that are shareholders in a passive foreign investment company, regardless of their percentage ownership in the company. One set of rules applies to passive foreign investment companies that are “qualified electing funds,” under which electing U.S. shareholders currently include in gross income their respective shares of the company’s earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received.<sup>145</sup> A second set of rules applies to passive foreign investment companies that are not qualified electing funds, under which U.S. shareholders pay tax on certain income or gain realized through the company, plus an interest charge that is attributable to the value of

---

<sup>138</sup> Sec. 951(a).

<sup>139</sup> Sec. 954.

<sup>140</sup> Sec. 953.

<sup>141</sup> Sec. 952(a)(3)-(5).

<sup>142</sup> Sec. 954.

<sup>143</sup> Secs. 951(a)(1)(B), 956.

<sup>144</sup> Sec. 1297.

<sup>145</sup> Sec. 1293-1295.

deferral.<sup>146</sup> A third set of rules applies to passive foreign investment company stock that is marketable, under which electing U.S. shareholders currently take into account as income (or loss) the difference between the fair market value of the stock as of the close of the taxable year and their adjusted basis in such stock (subject to certain limitations), often referred to as “marking to market.”<sup>147</sup>

Under section 1297(e), which was enacted in 1997 to address the overlap of the passive foreign investment company rules and subpart F, a controlled foreign corporation generally is not also treated as a passive foreign investment company with respect to a U.S. shareholder of the corporation. This exception applies regardless of the likelihood that the U.S. shareholder would actually be taxed under subpart F in the event that the controlled foreign corporation earns subpart F income. Thus, even in a case in which a controlled foreign corporation’s subpart F income would be allocated to a different shareholder under the subpart F allocation rules, a U.S. shareholder would still qualify for the exception from the passive foreign investment company rules under section 1297(e).

### **Description of Proposal**

The proposal adds an exception to section 1297(e) for U.S. shareholders that face only a remote likelihood of incurring a subpart F inclusion in the event that a controlled foreign corporation earns subpart F income, thus preserving the potential application of the passive foreign investment company rules in such cases.

### **Effective Date**

The proposal is effective for taxable years of controlled foreign corporations beginning after February 13, 2003, and for taxable years of U.S. shareholders in which or with which such taxable years of controlled foreign corporations end.

---

<sup>146</sup> Sec. 1291.

<sup>147</sup> Sec. 1296.



## **D. Impose Mark-to-Market Tax on Individuals Who Expatriate**

### **Present Law**

#### **In general**

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

#### **Income tax rules with respect to expatriates**

An individual who relinquishes his or her U.S. citizenship or terminates his or her U.S. residency with a principal purpose of avoiding U.S. taxes is subject to an alternative method of income taxation for the 10 taxable years ending after the expatriation or residency termination under section 877. The alternative method of taxation for expatriates modifies the rules generally applicable to the taxation of nonresident noncitizens in several ways. First, the individual is subject to tax on his or her U.S.-source income at the rates applicable to U.S. citizens rather than the rates applicable to other nonresident noncitizens. Unlike U.S. citizens, however, individuals subject to section 877 are not taxed on foreign-source income. Second, the scope of items treated as U.S.-source income for section 877 purposes is broader than those items generally considered to be U.S.-source income under the Code.<sup>148</sup> Third, individuals subject to section 877 are taxed on exchanges of certain types of property that give rise to U.S.-source income for property that gives rise to foreign-source income.<sup>149</sup> Fourth, an individual subject to section 877 who contributes property to a controlled foreign corporation is treated as receiving income or gain from such property directly and is taxable on such income or gain. The alternative method of taxation for expatriates

---

<sup>148</sup> For example, gains on the sale or exchange of personal property located in the United States, and gains on the sale or exchange of stocks and securities issued by U.S. persons, generally are not considered to be U.S.-source income under the Code. Thus, such gains would not be taxable to a nonresident noncitizen. However, if an individual is subject to the alternative regime under sec. 877, such gains are treated as U.S.-source income with respect to that individual.

<sup>149</sup> For example, a former citizen who is subject to the alternative tax regime and who removes appreciated artwork that he or she owns from the United States could be subject to immediate U.S. tax on the appreciation. In this regard, the removal from the United States of appreciated tangible personal property having an aggregate fair market value in excess of \$250,000 within the 15-year period beginning five years prior to the expatriation will be treated as an “exchange” subject to these rules.

applies only if it results in a higher U.S. tax liability than would otherwise be determined if the individual were taxed as a nonresident noncitizen.

The expatriation tax provisions apply to long-term residents of the United States whose U.S. residency is terminated. For this purpose, a long-term resident is any individual who was a lawful permanent resident of the United States for at least 8 out of the 15 taxable years ending with the year in which such termination occurs. In applying the 8-year test, an individual is not considered to be a lawful permanent resident for any year in which the individual is treated as a resident of another country under a treaty tie-breaker rule (and the individual does not elect to waive the benefits of such treaty).

Subject to the exceptions described below, an individual is treated as having expatriated or terminated residency with a principal purpose of avoiding U.S. taxes if either: (1) the individual's average annual U.S. Federal income tax liability for the 5 taxable years ending before the date of the individual's loss of U.S. citizenship or termination of U.S. residency is greater than \$100,000 (the "tax liability test"), or (2) the individual's net worth as of the date of such loss or termination is \$500,000 or more (the "net worth test"). The dollar amount thresholds contained in the tax liability test and the net worth test are indexed for inflation in the case of a loss of citizenship or termination of residency occurring in any calendar year after 1996. An individual who falls below these thresholds is not automatically treated as having a principal purpose of tax avoidance, but nevertheless is subject to the expatriation tax provisions if the individual's loss of citizenship or termination of residency in fact did have as one of its principal purposes the avoidance of tax.

Certain exceptions from the treatment that an individual relinquished his or her U.S. citizenship or terminated his or her U.S. residency for tax avoidance purposes may also apply. For example, a U.S. citizen who loses his or her citizenship and who satisfies either the tax liability test or the net worth test (described above) can avoid being deemed to have a principal purpose of tax avoidance if the individual falls within certain categories (such as being a dual citizen) and the individual, within one year from the date of loss of citizenship, submits a ruling request for a determination by the Secretary of the Treasury as to whether such loss had as one of its principal purposes the avoidance of taxes.

### **Estate tax rules with respect to expatriates**

Nonresident noncitizens generally are subject to estate tax on certain transfers of U.S.-situated property at death.<sup>150</sup> Such property includes real estate and tangible property located within the United States. Moreover, for estate tax purposes, stock held by nonresident noncitizens is treated as U.S.-situated if issued by a U.S. corporation.

---

<sup>150</sup> The Economic Growth and Tax Relief Reconciliation Act of 2001 (the "Act") repealed the estate tax for estates of decedents dying after December 31, 2009. However, the Act included a "sunset" provision, pursuant to which the Act's provisions (including estate tax repeal) do not apply to estates of decedents dying after December 31, 2010.

Special rules apply to U.S. citizens who relinquish their citizenship and long-term residents who terminate their U.S. residency within the 10 years prior to the date of death, unless the loss of status did not have as one its principal purposes the avoidance of tax (sec. 2107). Under these rules, the decedent's estate includes the proportion of the decedent's stock in a foreign corporation that the fair market value of the U.S.-situs assets owned by the corporation bears to the total assets of the corporation. This rule applies only if (1) the decedent owned, directly, at death 10 percent or more of the combined voting power of all voting stock of the corporation and (2) the decedent owned, directly or indirectly, at death more than 50 percent of the total voting stock of the corporation or more than 50 percent of the total value of all stock of the corporation.

Taxpayers are deemed to have a principal purpose of tax avoidance if they meet the five-year tax liability test or the net worth test, discussed above. Exceptions from this tax avoidance treatment apply in the same circumstances as those described above (relating to certain dual citizens and other individuals who submit a timely and complete ruling request with the IRS as to whether their expatriation or residency termination had a principal purpose of tax avoidance).

### **Gift tax rules with respect to expatriates**

Nonresident noncitizens generally are subject to gift tax on certain transfers by gift of U.S.-situated property. Such property includes real estate and tangible property located within the United States. Unlike the estate tax rules for U.S. stock held by nonresidents, however, nonresident noncitizens generally are not subject to U.S. gift tax on the transfer of intangibles, such as stock or securities, regardless of where such property is situated.

Special rules apply to U.S. citizens who relinquish their U.S. citizenship or long-term residents of the United States who terminate their U.S. residency within the 10 years prior to the date of transfer, unless such loss did not have as one of its principal purposes the avoidance of tax (sec. 2501(a)(3)). Under these rules, nonresident noncitizens are subject to gift tax on transfers of intangibles, such as stock or securities. Taxpayers are deemed to have a principal purpose of tax avoidance if they meet the five-year tax liability test or the net worth test, discussed above. Exceptions from this tax avoidance treatment apply in the same circumstances as those described above (relating to certain dual citizens and other individuals who submit a timely and complete ruling request with the IRS as to whether their expatriation or residency termination had a principal purpose of tax avoidance).

### **Other tax rules with respect to expatriates**

The expatriation tax provisions permit a credit against the U.S. tax imposed under such provisions for any foreign income, gift, estate, or similar taxes paid with respect to the items subject to such taxation. This credit is available only against the tax imposed solely as a result of the expatriation tax provisions, and is not available to be used to offset any other U.S. tax liability.

In addition, certain information reporting requirements apply. Under these rules, a U.S. citizen who loses his or her citizenship is required to provide a statement to the State Department (or other designated government entity) that includes the individual's social security number, forwarding foreign address, new country of residence and citizenship, a balance sheet in the case of individuals with a net worth of at least \$500,000, and such other information as the Secretary may prescribe. The information statement must be provided no later than the earliest day on which the individual (1) renounces the individual's U.S. nationality before a diplomatic or consular officer of the United States, (2) furnishes to the U.S. Department of State a statement of voluntary relinquishment of U.S. nationality confirming an act of expatriation, (3) is issued a certificate of loss of U.S. nationality by the U.S. Department of State, or (4) loses U.S. nationality because the individual's certificate of naturalization is canceled by a U.S. court. The entity to which such statement is to be provided is required to provide to the Secretary of the Treasury copies of all statements received and the names of individuals who refuse to provide such statements. A long-term resident whose U.S. residency is terminated is required to attach a similar statement to his or her U.S. income tax return for the year of such termination. An individual's failure to provide the required statement results in the imposition of a penalty for each year the failure continues equal to the greater of (1) 5 percent of the individual's expatriation tax liability for such year, or (2) \$1,000.

The State Department is required to provide the Secretary of the Treasury with a copy of each certificate of loss of nationality approved by the State Department. Similarly, the agency administering the immigration laws is required to provide the Secretary of the Treasury with the name of each individual whose status as a lawful permanent resident has been revoked or has been determined to have been abandoned. Further, the Secretary of the Treasury is required to publish in the Federal Register the names of all former U.S. citizens with respect to whom it receives the required statements or whose names or certificates of loss of nationality it receives under the foregoing information-sharing provisions.

### **Immigration rules with respect to expatriates**

Under U.S. immigration laws, any former U.S. citizen who officially renounces his or her U.S. citizenship and who is determined by the Attorney General to have renounced for the purpose of U.S. tax avoidance is ineligible to receive a U.S. visa and will be denied entry into the United States. This provision was included as an amendment (the "Reed amendment") to immigration legislation that was enacted in 1996.

### **Description of Proposal**

#### **In general**

The proposal generally subjects certain U.S. citizens who relinquish their U.S. citizenship and certain long-term U.S. residents who terminate their U.S. residence to tax on the net unrealized gain in their property as if such property were sold for fair market value on the day before the expatriation or residency termination. Gain from the deemed

sale is taken into account at that time without regard to other Code provisions; any loss from the deemed sale generally would be taken into account to the extent otherwise provided in the Code. Any net gain on the deemed sale is recognized to the extent it exceeds \$600,000 (\$1.2 million in the case of married individuals filing a joint return, both of whom relinquish citizenship or terminate residency). The \$600,000 amount is increased by a cost of living adjustment factor for calendar years after 2002.

### **Individuals covered**

Under the proposal, the mark-to-market tax applies to U.S. citizens who relinquish citizenship and long-term residents who terminate U.S. residency. An individual is a long-term resident if he or she was a lawful permanent resident for at least eight out of the 15 taxable years ending with the year in which the termination of residency occurs. An individual is considered to terminate long-term residency when either the individual ceases to be a lawful permanent resident (i.e., loses his or her green card status), or the individual is treated as a resident of another country under a tax treaty and the individual does not waive the benefits of the treaty.

Exceptions from the mark-to-market tax are provided in two situations. The first exception applies to an individual who was born with citizenship both in the United States and in another country; provided that (1) as of the expatriation date the individual continues to be a citizen of, and is taxed as a resident of, such other country, and (2) the individual was not a resident of the United States for the five taxable years ending with the year of expatriation. The second exception applies to a U.S. citizen who relinquishes U.S. citizenship before reaching age 18 and a half, provided that the individual was a resident of the United States for no more than five taxable years before such relinquishment.

### **Election to be treated as a U.S. citizen**

Under the proposal, an individual is permitted to make an irrevocable election to continue to be taxed as a U.S. citizen with respect to all property that otherwise is covered by the expatriation tax. This election is an “all or nothing” election; an individual is not permitted to elect this treatment for some property but not for other property. The election, if made, would apply to all property that would be subject to the expatriation tax and to any property the basis of which is determined by reference to such property. Under this election, the individual would continue to pay U.S. income taxes at the rates applicable to U.S. citizens following expatriation on any income generated by the property and on any gain realized on the disposition of the property. In addition, the property would continue to be subject to U.S. gift, estate, and generation-skipping transfer taxes. In order to make this election, the taxpayer would be required to waive any treaty rights that would preclude the collection of the tax.

The individual also would be required to provide security to ensure payment of the tax under this election in such form, manner, and amount as the Secretary of the Treasury requires. The amount of mark-to-market tax that would have been owed but for this election (including any interest, penalties, and certain other items) shall be a lien in

favor of the United States on all U.S.-situs property owned by the individual. This lien shall arise on the expatriation date and shall continue until the tax liability is satisfied, the tax liability has become unenforceable by reason of lapse of time, or the Secretary is satisfied that no further tax liability may arise by reason of this proposal. The rules of section 6324A(d)(1), (3), and (4) (relating to liens arising in connection with the deferral of estate tax under section 6166) apply to liens arising under this proposal.

### **Date of relinquishment of citizenship**

Under the proposal, an individual is treated as having relinquished U.S. citizenship on the earliest of four possible dates: (1) the date that the individual renounces U.S. nationality before a diplomatic or consular officer of the United States (provided that the voluntary relinquishment is later confirmed by the issuance of a certificate of loss of nationality); (2) the date that the individual furnishes to the State Department a signed statement of voluntary relinquishment of U.S. nationality confirming the performance of an expatriating act (again, provided that the voluntary relinquishment is later confirmed by the issuance of a certificate of loss of nationality); (3) the date that the State Department issues a certificate of loss of nationality; or (4) the date that a U.S. court cancels a naturalized citizen's certificate of naturalization.

### **Deemed sale of property upon expatriation or residency termination**

The deemed sale rule of the proposal generally applies to all property interests held by the individual on the date of relinquishment of citizenship or termination of residency. Special rules apply in the case of trust interests, as described below. U.S. real property interests, which remain subject to U.S. tax in the hands of nonresident noncitizens, generally are excepted from the proposal. Regulatory authority is granted to the Treasury to except other types of property from the proposal.

Under the proposal, an individual who is subject to the mark-to-market tax is required to pay a tentative tax equal to the amount of tax that would be due for a hypothetical short tax year ending on the date the individual relinquished citizenship or terminated residency. Thus, the tentative tax is based on all income, gain, deductions, loss, and credits of the individual for the year through such date, including amounts realized from the deemed sale of property. The tentative tax is due on the 90th day after the date of relinquishment of citizenship or termination of residency.

### **Retirement plans and similar arrangements**

Subject to certain exceptions, the proposal applies to all property interests held by the individual at the time of relinquishment of citizenship or termination of residency. Accordingly, such property includes an interest in an employer-sponsored retirement plan or deferred compensation arrangement as well as an interest in an individual retirement

account or annuity (i.e., an IRA).<sup>151</sup> However, the proposal contains a special rule for an interest in a “qualified retirement plan.” For purposes of the proposal, a “qualified retirement plan” includes an employer-sponsored qualified plan (sec. 401(a)), a qualified annuity (sec. 403(a)), a tax-sheltered annuity (sec. 403(b)), an eligible deferred compensation plan of a governmental employer (sec. 457(b)), or an IRA (sec. 408). The special retirement plan rule applies also, to the extent provided in regulations, to any foreign plan or similar retirement arrangement or program. An interest in a trust that is part of a qualified retirement plan or other arrangement that is subject to the special retirement plan rule is not subject to the rules for interests in trusts (discussed below).

Under the special rule, an amount equal to the present value of the individual’s vested, accrued benefit under a qualified retirement plan is treated as having been received by the individual as a distribution under the plan on the day before the individual’s relinquishment of citizenship or termination of residency. It is not intended that the plan would be deemed to have made a distribution for purposes of the tax-favored status of the plan, such as whether a plan may permit distributions before a participant has severed employment. In the case of any later distribution to the individual from the plan, the amount otherwise includible in the individual’s income as a result of the distribution is reduced to reflect the amount previously included in income under the special retirement plan rule. The amount of the reduction applied to a distribution is the excess of: (1) the amount included in income under the special retirement plan rule over (2) the total reductions applied to any prior distributions. However, under the proposal, the retirement plan, and any person acting on the plan’s behalf, will treat any later distribution in the same manner as the distribution would be treated without regard to the special retirement plan rule.

It is expected that the Treasury Department will provide guidance for determining the present value of an individual’s vested, accrued benefit under a qualified retirement plan, such as the individual’s account balance in the case of a defined contribution plan or an IRA, or present value determined under the qualified joint and survivor annuity rules applicable to a defined benefit plan (sec. 417(e)).

### **Deferral of payment of tax**

Under the proposal, an individual is permitted to elect to defer payment of the mark-to-market tax imposed on the deemed sale of the property. Interest is charged for the period the tax is deferred at a rate two percentage points higher than the rate normally applicable to individual underpayments. Under this election, the mark-to-market tax attributable to a particular property is due when the property is disposed of (or, if the property is disposed of in whole or in part in a nonrecognition transaction, at such other time as the Secretary may prescribe). The mark-to-market tax attributable to a particular property is an amount that bears the same ratio to the total mark-to-market tax for the

---

<sup>151</sup> Application of the provision is not limited to an interest that meets the definition of property under section 83 (relating to property transferred in connection with the performance of services).

year as the gain taken into account with respect to such property bears to the total gain taken into account under these rules for the year. The deferral of the mark-to-market tax may not be extended beyond the individual's death.

In order to elect deferral of the mark-to-market tax, the individual is required to provide adequate security to the Treasury to ensure that the deferred tax and interest will be paid. Other security mechanisms are permitted provided that the individual establishes to the satisfaction of the Secretary that the security is adequate. In the event that the security provided with respect to a particular property subsequently becomes inadequate and the individual fails to correct the situation, the deferred tax and the interest with respect to such property will become due. As a further condition to making the election, the individual is required to consent to the waiver of any treaty rights that would preclude the collection of the tax.

The deferred amount (including any interest, penalties, and certain other items) shall be a lien in favor of the United States on all U.S.-situs property owned by the individual. This lien shall arise on the expatriation date and shall continue until the tax liability is satisfied, the tax liability has become unenforceable by reason of lapse of time, or the Secretary is satisfied that no further tax liability may arise by reason of this proposal. The rules of section 6324A(d)(1), (3), and (4) (relating to liens arising in connection with the deferral of estate tax under section 6166) apply to liens arising under this proposal.

### **Interests in trusts**

Under the proposal, detailed rules apply to trust interests held by an individual at the time of relinquishment of citizenship or termination of residency. The treatment of trust interests depends on whether the trust is a qualified trust. A trust is a qualified trust if a court within the United States is able to exercise primary supervision over the administration of the trust and one or more U.S. persons have the authority to control all substantial decisions of the trust.

Constructive ownership rules apply to a trust beneficiary that is a corporation, partnership, trust, or estate. In such cases, the shareholders, partners, or beneficiaries of the entity are deemed to be the direct beneficiaries of the trust for purposes of applying these proposals. In addition, an individual who holds (or who is treated as holding) a trust instrument at the time of relinquishment of citizenship or termination of residency is required to disclose on his or her tax return the methodology used to determine his or her interest in the trust, and whether such individual knows (or has reason to know) that any other beneficiary of the trust uses a different method.

Nonqualified trusts.—If an individual holds an interest in a trust that is not a qualified trust, a special rule applies for purposes of determining the amount of the mark-to-market tax due with respect to such trust interest. The individual's interest in the trust is treated as a separate trust consisting of the trust assets allocable to such interest. Such separate trust is treated as having sold its net assets as of the date of relinquishment of citizenship or termination of residency and having distributed the assets to the individual,



who then is treated as having recontributed the assets to the trust. The individual is subject to the mark-to-market tax with respect to any net income or gain arising from the deemed distribution from the trust.

The election to defer payment is available for the mark-to-market tax attributable to a nonqualified trust interest. Interest is charged for the period the tax is deferred at a rate two percentage points higher than the rate normally applicable to individual underpayments. A beneficiary's interest in a nonqualified trust is determined under all the facts and circumstances, including the trust instrument, letters of wishes, and historical patterns of trust distributions.

Qualified trusts.—If an individual has an interest in a qualified trust, the amount of unrealized gain allocable to the individual's trust interest is calculated at the time of expatriation or residency termination. In determining this amount, all contingencies and discretionary interests are assumed to be resolved in the individual's favor (i.e., the individual is allocated the maximum amount that he or she could receive). The mark-to-market tax imposed on such gains is collected when the individual receives distributions from the trust, or if earlier, upon the individual's death. Interest is charged for the period the tax is deferred at a rate two percentage points higher than the rate normally applicable to individual underpayments.

If an individual has an interest in a qualified trust, the individual is subject to the mark-to-market tax upon the receipt of distributions from the trust. These distributions also may be subject to other U.S. income taxes. If a distribution from a qualified trust is made after the individual relinquishes citizenship or terminates residency, the mark-to-market tax is imposed in an amount equal to the amount of the distribution multiplied by the highest tax rate generally applicable to trusts and estates, but in no event will the tax imposed exceed the deferred tax amount with respect to the trust interest. For this purpose, the deferred tax amount is equal to (1) the tax calculated with respect to the unrealized gain allocable to the trust interest at the time of expatriation or residency termination, (2) increased by interest thereon, and (3) reduced by any mark-to-market tax imposed on prior trust distributions to the individual.

If any individual's interest in a trust is vested as of the expatriation date (e.g., if the individual's interest in the trust is non-contingent and non-discretionary), the gain allocable to the individual's trust interest is determined based on the trust assets allocable to his or her trust interest. If the individual's interest in the trust is not vested as of the expatriation date (e.g., if the individual's trust interest is a contingent or discretionary interest), the gain allocable to his or her trust interest is determined based on all of the trust assets that could be allocable to his or her trust interest, determined by resolving all contingencies and discretionary powers in the individual's favor. In the case where more than one trust beneficiary is subject to the expatriation tax with respect to trust interests that are not vested, the rules are intended to apply so that the same unrealized gain with respect to assets in the trust is not taxed to both individuals.

Mark-to-market taxes become due if the trust ceases to be a qualified trust, the individual disposes of his or her qualified trust interest, or the individual dies. In such

cases, the amount of mark-to-market tax equals the lesser of (1) the tax calculated under the rules for nonqualified trust interests as of the date of the triggering event, or (2) the deferred tax amount with respect to the trust interest as of that date.

The tax that is imposed on distributions from a qualified trust generally is deducted and withheld by the trustees. If the individual does not agree to waive treaty rights that would preclude collection of the tax, the tax with respect to such distributions is imposed on the trust, the trustee is personally liable for the tax, and any other beneficiary has a right of contribution against such individual with respect to the tax. Similar rules apply when the qualified trust interest is disposed of, the trust ceases to be a qualified trust, or the individual dies.

### **Coordination with present-law alternative tax regime**

The proposal provides a coordination rule with the present-law alternative tax regime. Under the proposal, the expatriation income tax rules under section 877, and the expatriation estate and gift tax rules under sections 2107 and 2501(a)(3) (described above), do not apply to a former citizen or former long-term resident whose expatriation or residency termination occurs on or after February 5, 2003.

### **Treatment of gifts and inheritances from a former citizen or former long-term resident**

Under the proposal, the exclusion from income provided in section 102 (relating to exclusions from income for the value of property acquired by gift or inheritance) does not apply to the value of any property received by gift or inheritance from a former citizen or former long-term resident (i.e., an individual who relinquished U.S. citizenship or terminated U.S. residency), subject to the exceptions described above relating to certain dual citizens and minors. Accordingly, a U.S. taxpayer who receives a gift or inheritance from such an individual is required to include the value of such gift or inheritance in gross income and is subject to U.S. tax on such amount. Having included the value of the property in income, the recipient would then take a basis in the property equal to that value. The tax does not apply to property that is shown on a timely filed gift tax return and that is a taxable gift by the former citizen or former long-term resident, or property that is shown on a timely filed estate tax return and included in the gross U.S. estate of the former citizen or former long-term resident (regardless of whether the tax liability shown on such a return is reduced by credits, deductions, or exclusions available under the estate and gift tax rules). In addition, the tax does not apply to property in cases in which no estate or gift tax return is required to be filed, where no such return would have been required to be filed if the former citizen or former long-term resident had not relinquished citizenship or terminated residency, as the case may be. Applicable gifts or bequests that are made in trust are treated as made to the beneficiaries of the trust in proportion to their respective interests in the trust.

### **Information reporting**

The proposal provides that certain information reporting requirements under present law (sec. 6039G) applicable to former citizens and former long-term residents also apply for purposes of the proposal.

### **Immigration rules**

The proposal amends the immigration rules that deny tax-motivated expatriates reentry into the United States by removing the requirement that the expatriation be tax-motivated, and instead denies former citizens reentry into the United States if the individual is determined not to be in compliance with his or her tax obligations under the proposal's expatriation tax proposals (regardless of the subjective motive for expatriating). For this purpose, the proposal permits the IRS to disclose certain items of return information of an individual, upon written request of the Attorney General or his delegate, as is necessary for making a determination under section 212(a)(10)(E) of the Immigration and Nationality Act. Specifically, the proposal would permit the IRS to disclose to the agency administering section 212(a)(10)(E) whether such taxpayer is in compliance with section 877A and identify the items of noncompliance. Recordkeeping requirements, safeguards, and civil and criminal penalties for unauthorized disclosure or inspection would apply to return information disclosed under this proposal.

### **Effective Date**

The proposal generally is effective for U.S. citizens who relinquish citizenship or long-term residents who terminate their residency on or after February 5, 2003. The provisions relating to gifts and inheritances are effective for gifts and inheritances received from former citizens and former long-term residents on or after February 5, 2003, whose expatriation or residency termination occurs on or after such date. The provisions relating to former citizens under U.S. immigration laws are effective on or after the date of enactment.

## **E. Extension of IRS User Fees**

### **Present Law**

The IRS provides written responses to questions of individuals, corporations, and organizations relating to their tax status or the effects of particular transactions for tax purposes. The IRS generally charges a fee for requests for a letter ruling, determination letter, opinion letter, or other similar ruling or determination. Public Law 104-117<sup>152</sup> extended the statutory authorization for these user fees<sup>153</sup> through September 30, 2003.

### **Description of Proposal**

The proposal extends the statutory authorization for these user fees through September 30, 2013. The proposal also moves the statutory authorization for these fees into the Code.<sup>154</sup>

### **Effective Date**

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

---

<sup>152</sup> An Act to provide that members of the Armed Forces performing services for the peacekeeping efforts in Bosnia and Herzegovina, Croatia, and Macedonia shall be entitled to tax benefits in the same manner as if such services were performed in a combat zone, and for other purposes (March 20, 1996).

<sup>153</sup> These user fees were originally enacted in section 10511 of the Revenue Act of 1987 (Pub. Law No. 100-203, December 22, 1987).

<sup>154</sup> The proposal also moves into the Code the user fee provision relating to pension plans that was enacted in section 620 of the Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub. L. 107-16, June 7, 2001).

## **F. Provisions to Discourage Corporate Expatriation**

### **1. Tax treatment of inversion transactions**

#### **Present Law**

##### **Determination of corporate residence**

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

##### **U.S. taxation of domestic corporations**

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

Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income is generally deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F<sup>155</sup> and the passive foreign investment company rules.<sup>156</sup> A foreign tax credit is generally available to offset, in whole or in part, the U.S. tax owed on this foreign-source income, whether repatriated as an actual dividend or included under one of the anti-deferral regimes.

##### **U.S. taxation of foreign corporations**

The United States taxes foreign corporations only on income that has a sufficient nexus to the United States. Thus, a foreign corporation is generally subject to U.S. tax only on income

---

<sup>155</sup> Secs. 951-964.

<sup>156</sup> Secs. 1291-1298.

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

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

### **U.S. tax treatment of inversion transactions**

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

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

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

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

### **Description of Proposal**

#### **In general**

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

#### **Transactions involving at least 80 percent identity of stock ownership**

The first type of inversion is a transaction in which, pursuant to a plan or a series of related transactions: (1) a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity;<sup>157</sup> (2) the former shareholders of the U.S. corporation hold (by reason of holding stock in the U.S. corporation) 80 percent or more (by vote or value) of the stock of the foreign-incorporated entity after the transaction; and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50 percent ownership (i.e., the "expanded affiliated group"), does not have substantial business activities in the entity's country of incorporation, compared to the total worldwide business activities of the expanded affiliated group. The provision denies the intended tax benefits of this type of inversion by deeming the top-tier foreign corporation to be a domestic corporation for all purposes of the Code.<sup>158</sup>

---

<sup>157</sup> It is expected that the Treasury Secretary will issue regulations applying the term "substantially all" in this context and will not be bound in this regard by interpretations of the term in other contexts under the Code.

<sup>158</sup> Since the top-tier foreign corporation is treated for all purposes of the Code as domestic, the shareholder-level "toll charge" of sec. 367(a) does not apply to these inversion transactions. However, with respect to inversion transactions completed before 2004, regulated

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

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

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

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

With respect to “toll charges,” any applicable corporate-level income or gain required to be recognized under sections 304, 311(b), 367, 1001, 1248, or any other provision with respect to the transfer of controlled foreign corporation stock or other assets by a U.S. corporation as part of the inversion transaction or after such transaction to a related foreign person is taxable,

---

investment companies and certain similar entities are allowed to elect to recognize gain as if sec. 367(a) did apply.



without offset by any tax attributes (e.g., net operating losses or foreign tax credits). To the extent provided in regulations, this rule will not apply to certain transfers of inventory and similar transactions conducted in the ordinary course of the taxpayer's business.

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

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

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

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

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

In cases in which a U.S. corporate group acquires subsidiaries or other assets from an unrelated inverted corporate group, the provisions described above generally do not apply to the acquiring U.S. corporate group or its related parties (including the newly acquired subsidiaries or

assets) by reason of acquiring the subsidiaries or assets that were connected with the inversion transaction. The Treasury Secretary is given authority to issue regulations appropriate to carry out the purposes of this provision and to prevent its abuse.

### **Partnership transactions**

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

### **Effective Date**

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

## **2. Excise tax on stock compensation of insiders of inverted corporations**

### **Present Law**

The income taxation of a nonstatutory<sup>159</sup> compensatory stock option is determined under the rules that apply to property transferred in connection with the performance of services (sec. 83). If a nonstatutory stock option does not have a readily ascertainable fair market value at the time of grant, which is generally the case unless the option is actively traded on an established market, no amount is included in the gross income of the recipient with respect to the option until the recipient exercises the option.<sup>160</sup> Upon exercise of such an option, the excess of the fair market value of the stock purchased over the option price is included in the recipient’s gross income as ordinary income in such taxable year.

---

<sup>159</sup> Nonstatutory stock options refer to stock options other than incentive stock options and employee stock purchase plans, the taxation of which is determined under sections 421-424.

<sup>160</sup> If an individual receives a grant of a nonstatutory option that has a readily ascertainable fair market value at the time the option is granted, the excess of the fair market value of the option over the amount paid for the option is included in the recipient’s gross income as ordinary income in the first taxable year in which the option is either transferable or not subject to a substantial risk of forfeiture.

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

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

### **Description of Proposal**

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

A disqualified individual is any individual who, with respect to a corporation, is, at any time during the 12-month period beginning on the date which is six months before the inversion date, subject to the requirements of section 16(a) of the Securities and Exchange Act of 1934 with respect to the corporation, or any member of the corporation's expanded affiliated group,<sup>161</sup> or would be subject to such requirements if the corporation (or member) were an issuer of equity securities referred to in section 16(a). Disqualified individuals generally include officers (as defined by section 16(a)),<sup>162</sup> directors, and 10-percent owners of private and publicly-held corporations.

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

---

<sup>161</sup> An expanded affiliated group is an affiliated group (under section 1504) except that such group is determined without regard to the exceptions for certain corporations and is determined applying a greater than 50 percent threshold, in lieu of the 80 percent test.

<sup>162</sup> An officer is defined as the president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice-president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions.

Specified stock compensation subject to the excise tax includes any payment<sup>163</sup> (or right to payment) granted by the inverted corporation (or any member of the corporation's expanded affiliated group) to any person in connection with the performance of services by a disqualified individual for such corporation (or member of the corporation's expanded affiliated group) if the value of the payment or right is based on, or determined by reference to, the value or change in value of stock of such corporation (or any member of the corporation's expanded affiliated group). In determining whether such compensation exists and valuing such compensation, all restrictions, other than non-lapse restrictions, are ignored. Thus, the excise tax applies, and the value subject to the tax is determined, without regard to whether such specified stock compensation is subject to a substantial risk of forfeiture or is exercisable at the time of the inversion transaction. Specified stock compensation includes compensatory stock and restricted stock grants, compensatory stock options, and other forms of stock-based compensation, including stock appreciation rights, phantom stock, and phantom stock options. Specified stock compensation also includes nonqualified deferred compensation that is treated as though it were invested in stock or stock options of the inverting corporation (or member). For example, the provision applies to a disqualified individual's deferred compensation if company stock is one of the actual or deemed investment options under the nonqualified deferred compensation plan.

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

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

---

<sup>163</sup> Under the provision, any transfer of property is treated as a payment and any right to a transfer of property is treated as a right to a payment.

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

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

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

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

in respect to the tax. Any payment made in respect of the tax is includible in the income of the individual, but is not deductible by the corporation.

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

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

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

#### **Effective Date**

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

### **3. Reinsurance agreements**

#### **Present Law**

In the case of a reinsurance agreement between two or more related persons, present law provides the Treasury Secretary with authority to allocate among the parties or recharacterize income (whether investment income, premium or otherwise), deductions, assets, reserves, credits and any other items related to the reinsurance agreement, or make any other adjustment, in order to reflect the proper source and character of the items for each party.<sup>164</sup> For this purpose, related persons are defined as in section 482. Thus, persons are related if they are organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) that are owned or controlled directly or indirectly by the same interests. The provision may apply to a contract even if one of the related parties is not a domestic company.<sup>165</sup> In addition, the provision also permits such allocation, recharacterization, or other adjustments in a case in which one of the parties to a reinsurance agreement is, with respect to

---

<sup>164</sup> Sec. 845(a).

<sup>165</sup> See S. Rep. No. 97-494, "Tax Equity and Fiscal Responsibility Act of 1982," July 12, 1982, 337 (describing provisions relating to the repeal of modified coinsurance provisions).

any contract covered by the agreement, in effect an agent of another party to the agreement, or a conduit between related persons.

### **Description of Proposal**

The proposal clarifies the rules of section 845, relating to authority for the Treasury Secretary to allocate items among the parties to a reinsurance agreement, recharacterize items, or make any other adjustment, in order to reflect the proper source and character of the items for each party. The proposal authorizes such allocation, recharacterization, or other adjustment, in order to reflect the proper source, character or amount of the item. It is intended that this authority<sup>166</sup> be exercised in a manner similar to the authority under section 482 for the Treasury Secretary to make adjustments between related parties. It is intended that this authority be applied in situations in which the related persons (or agents or conduits) are engaged in cross-border transactions that require allocation, recharacterization, or other adjustments in order to reflect the proper source, character or amount of the item or items. No inference is intended that present law does not provide this authority with respect to reinsurance agreements.

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

### **Effective Date**

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

---

<sup>166</sup> The authority to allocate, recharacterize or make other adjustments was granted in connection with the repeal of provisions relating to modified coinsurance transactions.

## **G. Add Vaccines Against Hepatitis A to the List of Taxable Vaccines**

### **Present Law**

A manufacturer's excise tax is imposed at the rate of 75 cents per dose<sup>167</sup> on the following vaccines routinely recommended for administration to children: diphtheria, pertussis, tetanus, measles, mumps, rubella, polio, HIB (haemophilus influenza type B), hepatitis B, varicella (chicken pox), rotavirus gastroenteritis, and streptococcus pneumoniae. The tax applied to any vaccine that is a combination of vaccine components equals 75 cents times the number of components in the combined vaccine.

Amounts equal to net revenues from this excise tax are deposited in the Vaccine Injury Compensation Trust Fund to finance compensation awards under the Federal Vaccine Injury Compensation Program for individuals who suffer certain injuries following administration of the taxable vaccines. This program provides a substitute Federal, "no fault" insurance system for the State-law tort and private liability insurance systems otherwise applicable to vaccine manufacturers. All persons immunized after September 30, 1988, with covered vaccines must pursue compensation under this Federal program before bringing civil tort actions under State law.

### **Description of Proposal**

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

### **Effective Date**

The proposal is effective for vaccines sold beginning on the first day of the first month beginning more than four weeks after the date of enactment.

---

<sup>167</sup> Sec. 4131.



## H. Disallowance of Certain Partnership Loss Transfers

### Present Law

#### Contributions of property

Under present law, if a partner contributes property to a partnership, generally no gain or loss is recognized to the contributing partner at the time of contribution.<sup>168</sup> The partnership takes the property at an adjusted basis equal to the contributing partner's adjusted basis in the property.<sup>169</sup> The contributing partner increases its basis in its partnership interest by the adjusted basis of the contributed property.<sup>170</sup> Any items of partnership income, gain, loss and deduction with respect to the contributed property is allocated among the partners to take into account any built-in gain or loss at the time of the contribution.<sup>171</sup> This rule is intended to prevent the transfer of built-in gain or loss from the contributing partner to the other partners by generally allocating items to the noncontributing partners based on the value of their contributions and by allocating to the contributing partner the remainder of each item.<sup>172</sup>

If the contributing partner transfers its partnership interest, the built-in gain or loss will be allocated to the transferee partner as it would have been allocated to the contributing partner.<sup>173</sup> If the contributing partner's interest is liquidated, there is no specific guidance preventing the allocation of the built-in loss to the remaining partners. Thus, it appears that losses can be "transferred" to other partners where the contributing partner no longer remains a partner.

#### Transfers of partnership interests

Under present law, a partnership does not adjust the basis of partnership property following the transfer of a partnership interest unless the partnership has made a one-time election under section 754 to make basis adjustments.<sup>174</sup> If an election is in effect, adjustments are made with respect to the transferee partner in order to account for the difference between the transferee partner's proportionate share of the adjusted basis of the partnership property and the

---

<sup>168</sup> Sec. 721.

<sup>169</sup> Sec. 723.

<sup>170</sup> Sec. 722

<sup>171</sup> Sec. 704(c)(1)(A).

<sup>172</sup> Where there is an insufficient amount of an item to allocate to the noncontributing partners, Treasury regulations allow for reasonable allocations to remedy this insufficiency. Treas. Reg. sec. 1-704(c) and (d).

<sup>173</sup> Treas. Reg. 1.704-3(a)(7).

<sup>174</sup> Sec. 743(a).

transferee's basis in its partnership interest.<sup>175</sup> These adjustments are intended to adjust the basis of partnership property to approximate the result of a direct purchase of the property by the transferee partner. Under these rules, if a partner purchases an interest in a partnership with an existing built-in loss and no election under section 754 in effect, the transferee partner may be allocated a share of the loss when the partnership disposes of the property (or depreciates the property).

### **Distributions of partnership property**

With certain exceptions, partners may receive distributions of partnership property without recognition of gain or loss by either the partner or the partnership.<sup>176</sup> In the case of a distribution in liquidation of a partner's interest, the basis of the property distributed in the liquidation is equal to the partner's adjusted basis in its partnership interest (reduced by any money distributed in the transaction).<sup>177</sup> In a distribution other than in liquidation of a partner's interest, the distributee partner's basis in the distributed property is equal to the partnership's adjusted basis in the property immediately before the distribution, but not to exceed the partner's adjusted basis in the partnership interest (reduced by any money distributed in the same transaction).<sup>178</sup>

Adjustments to the basis of the partnership's undistributed properties are not required unless the partnership has made the election under section 754 to make basis adjustments.<sup>179</sup> If an election is in effect under section 754, adjustments are made by a partnership to increase or decrease the remaining partnership assets to reflect any increase or decrease in the adjusted basis of the distributed properties in the hands of the distributee partner.<sup>180</sup> To the extent the adjusted basis of the distributed properties increases (or loss is recognized) the partnership's adjusted basis in its properties is decreased by a like amount; likewise, to the extent the adjusted basis of the distributed properties decrease (or gain is recognized), the partnership's adjusted basis in its properties is increased by a like amount. Under these rules, a partnership with no election in effect under section 754 may distribute property with an adjusted basis lower than the distributee partner's proportionate share of the adjusted basis of all partnership property and leave the remaining partners with a smaller net built-in gain or a larger net built-in loss than before the distribution.

---

<sup>175</sup> Sec. 743(b).

<sup>176</sup> Sec. 731(a) and (b).

<sup>177</sup> Sec. 732(b).

<sup>178</sup> Sec. 732(a).

<sup>179</sup> Sec. 734(a).

<sup>180</sup> Sec. 734(b).

## **Description of Proposal**

### **Contributions of property**

Under the proposal, a built-in loss may be taken into account only by the contributing partner and not by other partners. Except as provided in regulations, in determining the amount of items allocated to partners other than the contributing partner, the basis of the contributed property is treated as the fair market value on the date of contribution. Thus, if the contributing partner's partnership interest is transferred or liquidated, the partnership's adjusted basis in the property is based on its fair market value at the date of contribution, and the built-in loss will be eliminated.<sup>181</sup>

### **Transfers of partnership interests**

The proposal provides that the basis adjustment rules under section 743 are in the case of the transfer of a partnership interest with respect to which there is a substantial built-in loss (rather than being elective as under present law). For this purpose, a substantial built-in loss exists if the transferee partner's proportionate share of the adjusted basis of the partnership property exceeds by more than \$250,000 the transferee partner's basis in the partnership interest in the partnership.

Thus, for example, assume that partner A sells his partnership interest to B for its fair market value of \$1 million. Also assume that B's proportionate share of the adjusted basis of the partnership assets is \$1.3 million. Under the bill, section 743(b) applies, so that a \$300,000 decrease is required to the adjusted basis of the partnership assets with respect to B. As a result, B would recognize no gain or loss if the partnership immediately sold all its assets for their fair market value.

### **Distribution of partnership property**

The proposal provides that the basis adjustments under section 734 are required in the case of a distribution with respect to which there is a substantial basis reduction. A substantial basis reduction means a downward adjustment of more than \$250,000 that would be made to the basis of partnership assets if a section 754 election were in effect.

Thus, for example, assume that A and B each contributed \$2.5 million to a newly formed partnership and C contributed \$5 million, and that the partnership purchased LMN stock for \$3 million and XYZ stock for \$7 million. Assume that the value of each stock declined to \$1 million. Assume LMN stock is distributed to C in liquidation of its partnership interest. As under present law, the basis of LMN stock in C's hands is \$5 million. Under present law, C would recognize a loss of \$4 million if the LMN stock were sold for \$1 million.

---

<sup>181</sup> It is intended that a corporation succeeding to attributes of the contributing corporate partner under section 381 shall be treated in the same manner as the contributing partner.

Under the proposal, however, there is a substantial basis adjustment because the \$2 million increase in the adjusted basis of LMN stock (sec. 734(b)(2)(B)) is greater than \$250,000. Thus, the partnership is required to decrease the basis of XYZ stock (under section 734(b)(2)) by \$2 million (the amount by which the basis LMN stock was increased), leaving a basis of \$5 million. If the XYZ stock were then sold by the partnership for \$1 million, A and B would each recognize a loss of \$2 million.

#### **Effective Date**

The proposal applies to contributions, transfers, and distributions (as the case may be) after the date of enactment.

## I. Treatment of Stripped Bonds to Apply to Stripped Interests in Bond and Preferred Stock Funds

### Present Law

#### Assignment of income in general

In general, an “income stripping” transaction involves a transaction in which the right to receive future income from income-producing property is separated from the property itself. In such transactions, it may be possible to generate artificial losses from the disposition of certain property or to defer the recognition of taxable income associated with such property.

Common law has developed a rule (referred to as the “assignment of income” doctrine) that income may not be transferred without also transferring the underlying property. A leading judicial decision relating to the assignment of income doctrine involved a case in which a taxpayer made a gift of detachable interest coupons before their due date while retaining the bearer bond. The U.S. Supreme Court ruled that the donor was taxable on the entire amount of interest when paid to the donee on the grounds that the transferor had “assigned” to the donee the right to receive the income.<sup>182</sup>

In addition to general common law assignment of income principles, specific statutory rules have been enacted to address certain specific types of stripping transactions, such as transactions involving stripped bonds and stripped preferred stock (which are discussed below).<sup>183</sup> However, there are no specific statutory rules that address stripping transactions with respect to common stock or other equity interests (other than preferred stock).<sup>184</sup>

Both the scope of the assignment of income doctrine and the extent to which the doctrine has been overruled by the subsequent enactment of specific statutory income stripping rules is unclear.

---

<sup>182</sup> *Helvering v. Horst*, 311 U.S. 112 (1940).

<sup>183</sup> Depending on the facts, the IRS also could determine that a variety of other Code-based and common law-based authorities could apply to income stripping transactions, including: (1) sections 269, 382, 446(b), 482, 701, or 704 and the regulations thereunder; (2) authorities that recharacterize certain assignments or accelerations of future payments as financings; (3) business purpose, economic substance, and sham transaction doctrines; (4) the step transaction doctrine; and (5) the substance-over-form doctrine. *See* Notice 95-53, 1995-2 C.B. 334 (accounting for lease strips and other stripping transactions).

<sup>184</sup> However, in *Estate of Stranahan v. Commissioner*, 472 F.2d 867 (6th Cir. 1973), the court held that where a taxpayer sold a carved-out interest of stock dividends, with no personal obligation to produce the income, the transaction was treated as a sale of an income interest.

## **Stripped bonds**

Special rules are provided with respect to the purchaser and “stripper” of stripped bonds.<sup>185</sup> A “stripped bond” is defined as a debt instrument in which there has been a separation in ownership between the underlying debt instrument and any interest coupon that has not yet become payable.<sup>186</sup> In general, upon the disposition of either the stripped bond or the detached interest coupons, the retained portion and the portion that is disposed of each is treated as a new bond that is purchased at a discount and is payable at a fixed amount on a future date. Accordingly, section 1286 treats both the stripped bond and the detached interest coupons as individual bonds that are newly issued with original issue discount (“OID”) on the date of disposition. Consequently, section 1286 effectively subjects the stripped bond and the detached interest coupons to the general OID periodic income inclusion rules.

A taxpayer who purchases a stripped bond or one or more stripped coupons is treated as holding a new bond that is issued on the purchase date with OID in an amount that is equal to the excess of the stated redemption price at maturity (or in the case of a coupon, the amount payable on the due date) over the ratable share of the purchase price of the stripped bond or coupon, determined on the basis of the respective fair market values of the stripped bond and coupons on the purchase date.<sup>187</sup> The OID on the stripped bond or coupon is includible in gross income under the general OID periodic income inclusion rules.

A taxpayer who strips a bond and disposes of either the stripped bond or one or more stripped coupons must allocate his basis, immediately before the disposition, in the bond (with the coupons attached) between the retained and disposed items.<sup>188</sup> Special rules apply to require that interest or market discount accrued on the bond prior to such disposition must be included in the taxpayer’s gross income (to the extent that it had not been previously included in income) at the time the stripping occurs, and the taxpayer increases his basis in the bond by the amount of such accrued interest or market discount. The adjusted basis (as increased by any accrued interest or market discount) is then allocated between the stripped bond and the stripped interest coupons in relation to their respective fair market values. Amounts realized from the sale of stripped coupons or bonds constitute income to the taxpayer only to the extent such amounts exceed the basis allocated to the stripped coupons or bond. With respect to retained items (either the detached coupons or stripped bond), to the extent that the price payable on maturity, or on the due date of the coupons, exceeds the portion of the taxpayer’s basis allocable to such retained

---

<sup>185</sup> Section 1286.

<sup>186</sup> Section 1286(e).

<sup>187</sup> Section 1286(a).

<sup>188</sup> Section 1286(b). Similar rules apply in the case of any person whose basis in any bond or coupon is determined by reference to the basis in the hands of a person who strips the bond.

items, the difference is treated as OID that is required to be included under the general OID periodic income inclusion rules.<sup>189</sup>

### **Stripped preferred stock**

“Stripped preferred stock” is defined as preferred stock in which there has been a separation in ownership between such stock and any dividend on such stock that has not become payable.<sup>190</sup> A taxpayer who purchases stripped preferred stock is required to include in gross income, as ordinary income, the amounts that would have been includible if the stripped preferred stock was a bond issued on the purchase date with OID equal to the excess of the redemption price of the stock over the purchase price.<sup>191</sup> This treatment is extended to any taxpayer whose basis in the stock is determined by reference to the basis in the hands of the purchaser. A taxpayer who strips and disposes the future dividends is treated as having purchased the stripped preferred stock on the date of such disposition for a purchase price equal to the taxpayer’s adjusted basis in the stripped preferred stock.<sup>192</sup>

### **Description of Proposal**

The proposal authorizes the Treasury Department to promulgate regulations that, in appropriate cases, apply rules that are similar to the present-law rules for stripped bonds and stripped preferred stock to direct or indirect interests in an entity or account substantially all of the assets of which consist of bonds (as defined in section 1286(e)(1)), preferred stock (as defined in section 305(e)(5)(B)), or any combination thereof. The proposal applies only to cases in which the present-law rules for stripped bonds and stripped preferred stock do not already apply to such interests.

For example, such Treasury regulations could apply to a transaction in which a person effectively strips future dividends from shares in a money market mutual fund (and disposes either the stripped shares or stripped future dividends) by contributing the shares (with the future dividends) to a custodial account through which another person purchases rights to either the stripped shares or the stripped future dividends. However, it is intended that Treasury regulations issued under this proposal would not apply to certain transactions involving direct or indirect interests in an entity or account substantially all the assets of which consist of tax-exempt obligations (as defined in section 1275(a)(3)), such as a tax-exempt bond partnership described in Rev. Proc. 2002-68, 2002-43 I.R.B. 753, *modifying and superceding* Rev. Proc. 2002-16, 2002-9 I.R.B. 572.

---

<sup>189</sup> Special rules are provided with respect to stripping transactions involving tax-exempt obligations that treat OID (computed under the stripping rules) in excess of OID computed on the basis of the bond’s coupon rate (or higher rate if originally issued at a discount) as income from a non-tax-exempt debt instrument (sec. 1286(d)).

<sup>190</sup> Section 305(e)(5).

<sup>191</sup> Section 305(e)(1).

<sup>192</sup> Section 305(e)(3).

No inference is intended as to the treatment under the present-law rules for stripped bonds and stripped preferred stock, or under any other provisions or doctrines of present law, of interests in an entity or account substantially all of the assets of which consist of bonds, preferred stock, or any combination thereof. The Treasury regulations, when issued, would be applied prospectively, except in cases to prevent abuse.

#### **Effective Date**

The proposal is effective for purchases and dispositions occurring after the date of enactment.



## **J. Reporting of Taxable Mergers and Acquisitions**

### **Present Law**

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

### **Description of Proposal**

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

- (1) A description of the transaction;
- (2) The name and address of each shareholder of the acquired corporation that recognizes gain as a result of the transaction (or would recognize gain, if there was a built-in gain on the shareholder's shares);
- (3) The amount of money and the value of stock or other consideration paid to each shareholder described above; and
- (4) Such other information as the Treasury Secretary may prescribe.

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

In addition, every person required to make a return described above is required to furnish to each shareholder whose name is required to be set forth in such return a written statement showing:

- (1) The name, address, and phone number of the information contact of the person required to make such return;
- (2) The information required to be shown on that return; and
- (3) Such other information as the Treasury Secretary may prescribe.

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

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

### **Effective Date**

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

## **K. Inclusion in Gross Income of Certain Deferred Compensation**

### **Present Law**

The determination of when amounts deferred under a nonqualified deferred compensation arrangement are includible in the gross income of the individual earning the compensation depends on the facts and circumstances of the arrangement. A variety of tax principles and Code provisions may be relevant in making this determination, including the doctrine of constructive receipt, the economic benefit doctrine,<sup>193</sup> the provisions of section 83 relating generally to transfers of property in connection with the performance of services, and provisions relating specifically to nonexempt employee trusts (sec. 402(b)) and nonqualified annuities (sec. 403(c)).

In general, the time for income inclusion of nonqualified deferred compensation depends on whether the arrangement is unfunded or funded. If the arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received. If the arrangement is funded, then income is includible for the year in which the individual's rights are transferable or not subject to a substantial risk of forfeiture.

Nonqualified deferred compensation is generally subject to social security and Medicare tax when it is earned (i.e., when services are performed), unless the nonqualified deferred compensation is subject to a substantial risk of forfeiture. If nonqualified deferred compensation is subject to a substantial risk of forfeiture, it is subject to social security and Medicare tax when the risk of forfeiture is removed (i.e., when the right to the nonqualified deferred compensation vests). This treatment is not affected by whether the arrangement is funded or unfunded, which is relevant in determining when amounts are includible in income (and subject to income tax withholding).

In general, an arrangement is considered funded if there has been a transfer of property under section 83. Under that section, a transfer of property occurs when a person acquires a beneficial ownership interest in such property. The term "property" is defined very broadly for purposes of section 83.<sup>194</sup> Property includes real and personal property other than money or an unfunded and unsecured promise to pay money in the future. Property also includes a beneficial interest in assets (including money) that are transferred or set aside from claims of the creditors of the transferor, for example, in a trust or escrow account. Accordingly, if, in connection with the performance of services, vested contributions are made to a trust on an individual's behalf and the trust assets may be used solely to provide future payments to the individual, the payment of the contributions to the trust constitutes a transfer of property to the individual that is taxable under section 83. On the other hand, deferred amounts are generally not includible in income in situations where nonqualified deferred compensation is payable from general corporate funds

---

<sup>193</sup> See, e.g., *Sproull v. Commissioner*, 16 T.C. 244 (1951), *aff'd per curiam*, 194 F.2d 541 (6th Cir. 1952); Rev. Rul. 60-31, 1960-1 C.B. 174.

<sup>194</sup> Treas. Reg. sec. 1.83-3(e). This definition in part reflects previous IRS rulings on nonqualified deferred compensation.

that are subject to the claims of general creditors, as such amounts are treated as unfunded and unsecured promises to pay money or property in the future.

As discussed above, if the arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received under section 451. Income is constructively received when it is credited to an individual's account, set apart, or otherwise made available so that it can be drawn on at any time. Income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. A requirement to relinquish a valuable right in order to make withdrawals is generally treated as a substantial limitation or restriction.

Special statutory provisions govern the timing of the deduction for nonqualified deferred compensation, regardless of whether the arrangement covers employees or nonemployees and regardless of whether the arrangement is funded or unfunded.<sup>195</sup> Under these provisions, the amount of nonqualified deferred compensation that is includible in the income of the individual performing services is deductible by the service recipient for the taxable year in which the amount is includible in the individual's income.

### **Rabbi trusts**

Arrangements have developed in an effort to provide employees with security for nonqualified deferred compensation, while still allowing deferral of income inclusion. A "rabbi trust" is a trust or other fund established by the employer to hold assets from which nonqualified deferred compensation payments will be made. The trust or fund is generally irrevocable and does not permit the employer to use the assets for purposes other than to provide nonqualified deferred compensation, except that the terms of the trust or fund provide that the assets are subject to the claims of the employer's creditors in the case of insolvency or bankruptcy.

As discussed above, for purposes of section 83, property includes a beneficial interest in assets set aside from the claims of creditors, such as in a trust or fund, but does not include an unfunded and unsecured promise to pay money in the future. In the case of a rabbi trust, terms providing that the assets are subject to the claims of creditors of the employer in the case of insolvency or bankruptcy have been the basis for the conclusion that the creation of a rabbi trust does not cause the related nonqualified deferred compensation arrangement to be funded for income tax purposes.<sup>196</sup> As a result, no amount is included in income by reason of the rabbi trust; generally income inclusion occurs as payments are made from the trust.

The IRS has issued guidance setting forth model rabbi trust provisions.<sup>197</sup> Revenue Procedure 92-64 provides a safe harbor for taxpayers who adopt and maintain grantor trusts in

---

<sup>195</sup> Secs. 404(a)(5), (b) and (d) and sec. 83(h).

<sup>196</sup> This conclusion was first provided in a 1980 private ruling issued by the IRS with respect to an arrangement covering a rabbi; hence the popular name "rabbi trust." Priv. Ltr. Rul. 8113107 (Dec. 31, 1980).

<sup>197</sup> Rev. Proc. 92-64, 1992-2 C.B. 422, modified in part by Notice 2000-56, 2000-2 C.B. 393.

connection with unfunded deferred compensation arrangements. The model trust language requires that the trust provide that all assets of the trust are subject to the claims of the general creditors of the company in the event of the company's insolvency or bankruptcy.

Since the concept of rabbi trusts was developed, arrangements have developed which attempt to protect the assets from creditors despite the terms of the trust. Arrangements also have developed which effectively allow deferred amounts to be available to participants, while still meeting the safe harbor requirements set forth by the IRS.

### **Description of Proposal**

Under the proposal, amounts deferred under a nonqualified deferred compensation plan<sup>198</sup> are currently includible in income unless certain requirements are satisfied. Distributions from nonqualified deferred compensation arrangements can only be distributed upon separation from service, disability, death, a specified time, change in control, or financial hardship. The deferred compensation plan cannot permit the acceleration of the time of such payment by reason of any event. Separation from service distributions to disqualified individuals (as defined in section 280G) cannot be made earlier than six months after the date of separation from service.

Amounts payable upon the occurrence of an event are not treated as amounts payable at a specified time. For example, amounts payable when an individual attains age 65 are payable at a specified time, while amounts payable when an individual's child begins college are payable upon the occurrence of an event.

Disability is defined as under the Social Security Act. Under such definition, an individual is considered to be disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than twelve months.

Financial hardship is defined as severe financial hardship of the participant or beneficiary resulting from an illness or accident of the participant or beneficiary, the participant's or beneficiary's spouse or the participant's or beneficiary's dependent (as defined in 152(a)); loss of the participant's or beneficiary's property due to casualty; or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant or beneficiary. The amount of the distribution must be limited to the amount needed to satisfy the hardship plus taxes. Distributions can not be allowed to the extent that the hardship may be relieved through reimbursement or compensation by insurance or otherwise, or by liquidation of the participant's assets (to the extent such liquidation would not itself cause financial hardship).

Under the proposal, change in control will be defined by the Secretary.

Initial deferrals must be required to be made no later than prior to the beginning of the taxable year that the compensation is earned. In the first year that an employee becomes eligible for participation in the plan, the election can be made within 30 days after the date that the

---

<sup>198</sup> A plan includes an agreement or arrangement.

employee is initially eligible. Subsequent elections to delay the timing or form of payment can be permitted only if the subsequent election is made more than 12 months prior to the date of the scheduled distribution and provides additional deferral for a period of not less than 5 years. A participant cannot be allowed to make more than one subsequent election. No accelerations can be allowed.

If impermissible distributions or elections are made, or if the plan or arrangement is amended to allow for impermissible distributions or elections, amounts deferred are currently includible in income. If the requirements of the proposal are not satisfied, in addition to current income inclusion, interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred. Interest imposed under the proposal is treated as interest on an underpayment of tax. Earnings on amounts deferred are also subject to the proposal.

Under the proposal, amounts deferred through an offshore trust are currently includible in income. In addition, amounts deferred under a nonqualified deferred compensation arrangement that provides that upon a change in the employer's financial health, assets will be restricted to the payment of deferred compensation would also be currently includible in income. The rule is violated upon the earlier of when the assets are so restricted or when the plan provides that assets will be restricted. Interest at the underpayment rate plus one percentage point is also imposed on the underpayments that would have occurred had the amounts deferred in an offshore trust or arrangement with financial trigger been includible in income for the taxable year such amounts were first set aside.

A nonqualified deferred compensation plan is any plan that provides for the deferral of compensation other than a qualified retirement plan.

Annual reporting to the IRS of amounts deferred is required under the proposal. Amounts deferred are required to be reported on an individual's Form W-2 for the year deferred even if the amount is not currently includible in income for that taxable year.

The proposal is not intended to preclude the application of other rules that would require earlier income inclusion. The proposal provides the Secretary of the Treasury authority to prescribe regulations as are necessary to carry out the proposal.

#### **Effective Date**

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

## **L. Minimum Holding Period for Foreign Tax Credit with respect to Withholding Taxes on Income other than Dividends**

### **Present Law**

In general, U.S. persons may credit foreign taxes against U.S. tax on foreign-source income. The amount of foreign tax credits that may be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S.-source income. Separate limitations are applied to specific categories of income.

As a consequence of the foreign tax credit limitations of the Code, certain taxpayers are unable to utilize their creditable foreign taxes to reduce their U.S. tax liability. U.S. taxpayers that are tax-exempt receive no U.S. tax benefit for foreign taxes paid on income that they receive.

Present law denies a U.S. shareholder the foreign tax credits normally available with respect to a dividend from a corporation or a regulated investment company (“RIC”) if the shareholder has not held the stock for more than 15 days (within a 30-day testing period) in the case of common stock or more than 45 days (within a 90-day testing period) in the case of preferred stock (sec. 901(k)). The disallowance applies both to foreign tax credits for foreign withholding taxes that are paid on the dividend where the dividend-paying stock is held for less than these holding periods, and to indirect foreign tax credits for taxes paid by a lower-tier foreign corporation or a RIC where any of the required stock in the chain of ownership is held for less than these holding periods. Periods during which a taxpayer is protected from risk of loss (e.g., by purchasing a put option or entering into a short sale with respect to the stock) generally are not counted toward the holding period requirement. In the case of a bona fide contract to sell stock, a special rule applies for purposes of indirect foreign tax credits. The disallowance does not apply to foreign tax credits with respect to certain dividends received by active dealers in securities. If a taxpayer is denied foreign tax credits because the applicable holding period is not satisfied, the taxpayer is entitled to a deduction for the foreign taxes for which the credit is disallowed.

### **Description of Proposal**

The proposal expands the present-law disallowance of foreign tax credits to include credits for gross-basis foreign withholding taxes with respect to any item of income or gain from property if the taxpayer who receives the income or gain has not held the property for more than 15 days (within a 30-day testing period), exclusive of periods during which the taxpayer is protected from risk of loss. The proposal does not apply to foreign tax credits that are subject to the present-law disallowance with respect to dividends. The proposal also does not apply to certain income or gain that is received with respect to property held by active dealers. Rules similar to the present-law disallowance for foreign tax credits with respect to dividends apply to foreign tax credits that are subject to the proposal. In addition, the proposal authorizes the Treasury Department to issue regulations providing that the proposal does not apply in appropriate cases.

### **Effective Date**

The provision is effective for amounts that are paid or accrued more than 30 days after the date of enactment.



## **M. Permit Private Sector Debt Collection Companies to Collect Tax Debts**

### **Present Law**

In fiscal years 1996 and 1997, the Congress earmarked \$13 million for IRS to test the use of private debt collection companies. There were several constraints on this pilot project. First, because both IRS and OMB considered the collection of taxes to be an inherently governmental function, only government employees were permitted to collect the taxes. The private debt collection companies were utilized to assist the IRS in locating and contacting taxpayers, reminding them of their outstanding tax liability, and suggesting payment options. If the taxpayer agreed at that point to make a payment, the taxpayer was transferred from the private debt collection company to the IRS. Second, the private debt collection companies were paid a flat fee for services rendered; the amount that was ultimately collected by the IRS was not taken into account in the payment mechanism.

The pilot program was discontinued because of disappointing results. GAO reported<sup>199</sup> that IRS collected \$3.1 million attributable to the private debt collection company efforts; expenses were also \$3.1 million. In addition, there were lost opportunity costs of \$17 million to the IRS because collection personnel were diverted from their usual collection responsibilities to work on the pilot.

The IRS has recently revised its extensive Request for Information concerning its possible use of private debt collection companies.<sup>200</sup>

In general, Federal agencies are permitted to enter into contracts with private debt collection companies for collection services to recover indebtedness owed to the United States.<sup>201</sup> That provision does not apply to the collection of debts under the Internal Revenue Code.<sup>202</sup>

### **Description of Proposal**

The proposal permits the IRS to use private debt collection companies to locate and contact taxpayers owing outstanding tax liabilities and to arrange payment of those taxes by the taxpayers. Several steps are involved. First, the private debt collection company contacts the taxpayer by letter.<sup>203</sup> If the taxpayer's last known address is incorrect, the private debt collection

---

<sup>199</sup> GAO/GGD-97-129R Issues Affecting IRS' Collection Pilot (July 18, 1997).

<sup>200</sup> TIRNO-03-H-0001 (February 14, 2003), at [www.procurement.irs.treas.gov](http://www.procurement.irs.treas.gov). The basic request for information is 104 pages, and there are 16 additional attachments.

<sup>201</sup> 31 U.S.C. 3718.

<sup>202</sup> 31 U.S.C. 3718(f).

<sup>203</sup> Several portions of the proposal require that the IRS disclose confidential taxpayer information to the private debt collection company. Section 6103(n) permits disclosure for "the

company searches for the correct address. The private debt collection company is not permitted to contact either individuals or employers to locate a taxpayer. Second, the private debt collection company telephones the taxpayer to request full payment.<sup>204</sup> If the taxpayer cannot pay in full immediately, the private debt collection company offers the taxpayer an installment agreement providing for full payment of the taxes over a period of up to three years. If the taxpayer is unable to pay the outstanding tax liability in full over a three-year period, the private debt collection company obtains financial information from the taxpayer and will provide this information to the IRS for further processing and action by the IRS.

The proposal specifies several procedural conditions under which the proposal would operate. First, provisions of the Fair Debt Collection Act apply to the private debt collection company.<sup>205</sup> Second, taxpayer protections that are statutorily applicable to the IRS are also made statutorily applicable to the private sector debt collection companies. Third, the private sector debt collection companies are required to inform taxpayers of the availability of assistance from the Taxpayer Advocate.

The proposal creates a revolving fund from the amounts collected by the private debt collection companies. The private debt collection companies are paid out of this fund. Their compensation would be “based upon a number of factors, including quality of service, taxpayer satisfaction, and case resolution, in addition to collection results.”<sup>206</sup>

### **Effective Date**

The proposal is effective after the date of enactment.

---

providing of other services ... for purposes of tax administration.” Accordingly, no amendment to 6103 is necessary to implement the proposal.

<sup>204</sup> It is anticipated that the private debt collection company will not accept payment directly; payments will be processed by IRS employees.

<sup>205</sup> This is present law.

<sup>206</sup> Treasury General Explanations, p. 99.

## **N. Repeal the exclusion for foreign earned income and the exclusion or deduction for housing expenses**

### **Present Law**

U.S. citizens generally are subject to U.S. income tax on all their income, whether derived in the United States or elsewhere. A U.S. citizen who earns income in a foreign country also may be taxed on such income by that foreign country. However, the United States generally cedes the primary right to tax income derived by a U.S. citizen from sources outside the United States to the foreign country where such income is derived. Accordingly, a credit against the U.S. income tax imposed on foreign source taxable income is provided for foreign taxes paid on that income.

U.S. citizens living abroad may be eligible to exclude from their income for U.S. tax purposes certain foreign earned income and foreign housing costs. In order to qualify for these exclusions, a U.S. citizen must be either: (1) a bona fide resident of a foreign country for an uninterrupted period that includes an entire taxable year; or (2) present overseas for 330 days out of any 12-consecutive-month period. In addition, the taxpayer must have his or her tax home in a foreign country.

The exclusion for foreign earned income generally applies to income earned from sources outside the United States as compensation for personal services actually rendered by the taxpayer. The maximum exclusion for foreign earned income for a taxable year is \$80,000 (for 2002 and thereafter). For taxable years beginning after 2007, the maximum exclusion amount is indexed for inflation.

The exclusion for housing costs applies to reasonable expenses, other than deductible interest and taxes, paid or incurred by or on behalf of the taxpayer for housing for the taxpayer and his or her spouse and dependents in a foreign country. The exclusion amount for housing costs for a taxable year is equal to the excess of such housing costs for the taxable year over an amount computed pursuant to a specified formula. In the case of housing costs that are not paid or reimbursed by the taxpayer's employer, the amount that would be excludible is treated instead as a deduction.

The combined earned income exclusion and housing cost exclusion may not exceed the taxpayer's total foreign earned income. The taxpayer's foreign tax credit is reduced by the amount of such credit that is attributable to excluded income.

Special exclusions apply in the case of taxpayers who reside in one of the U.S. possessions.

### **Description of the Proposal**

The proposal repeals the exclusion for foreign earned income and the exclusion or deduction for housing expenses.

**Effective Date**

The proposal is effective for taxable years beginning after December 31, 2004.

## **O. Modify Qualification Rules for Tax-Exempt Property and Casualty Insurance Companies**

### **Present Law**

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

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

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

### **Description of Proposal**

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

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

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

### **Effective Date**

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

**P. Authorize IRS to Enter into Installment Agreements  
that Provide for Partial Payment**

**Present Law**

The Code authorizes the IRS to enter into written agreements with any taxpayer under which the taxpayer is allowed to pay taxes owed, as well as interest and penalties, in installment payments if the IRS determines that doing so will facilitate collection of the amounts owed (sec. 6159). An installment agreement does not reduce the amount of taxes, interest, or penalties owed. Generally, during the period installment payments are being made, other IRS enforcement actions (such as levies or seizures) with respect to the taxes included in that agreement are held in abeyance.

Prior to 1998, the IRS administratively entered into installment agreements that provided for partial payment (rather than full payment) of the total amount owed over the period of the agreement. In that year, the IRS Chief Counsel issued a memorandum concluding that partial payment installment agreements were not permitted.

**Description of Proposal**

The proposal clarifies that the IRS is authorized to enter into installment agreements with taxpayers which do not provide for full payment of the taxpayer's liability over the life of the agreement. The proposal also requires the IRS to review partial payment installment agreements at least every two years. The primary purpose of this review is to determine whether the financial condition of the taxpayer has significantly changed so as to warrant an increase in the value of the payments being made.

**Effective Date**

The proposal is effective for installment agreements entered into on or after the date of enactment.

## **Q. Denial of Deduction for Certain Fines, Penalties, and Other Amounts**

### **Present Law**

Under present law, no deduction is allowed as a trade or business expense under section 162(a) for the payment of a fine or similar penalty to a government for the violation of any law (sec. 162(f)). The enactment of section 162(f) in 1969 codified existing case law that denied the deductibility of fines as ordinary and necessary business expenses on the grounds that “allowance of the deduction would frustrate sharply defined national or State policies proscribing the particular types of conduct evidenced by some governmental declaration thereof.”<sup>207</sup>

Treasury regulation section 1.162-21(b)(1) provides that a fine or similar penalty includes an amount: (1) paid pursuant to conviction or a plea of guilty or *nolo contendere* for a crime (felony or misdemeanor) in a criminal proceeding; (2) paid as a civil penalty imposed by Federal, State, or local law, including additions to tax and additional amounts and assessable penalties imposed by chapter 68 of the Code; (3) paid in settlement of the taxpayer’s actual or potential liability for a fine or penalty (civil or criminal); or (4) forfeited as collateral posted in connection with a proceeding which could result in imposition of such a fine or penalty. Treasury regulation section 1.162-21(b)(2) provides, among other things, that compensatory damages (including damages under section 4A of the Clayton Act (15 U.S.C. 15a), as amended) paid to a government do not constitute a fine or penalty.

### **Description of Proposal**

The proposal modifies the rules regarding the determination whether payments are nondeductible payments of fines or penalties under section 162(f). In particular, the proposal generally provides that amounts paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government in relation to the violation of any law or the investigation or inquiry into the potential violation of any law are nondeductible under any provision of the income tax provisions.<sup>208</sup> The proposal applies to deny a deduction for any such payments, including those where there is no admission of guilt or liability and those made for the purpose of avoiding further investigation or litigation. An exception applies to payments that the taxpayer establishes are restitution.<sup>209</sup>

It is intended that a payment will be treated as restitution only if the payment is required to be paid to the specific persons, or in relation to the specific property, actually harmed by the conduct of the taxpayer that resulted in the payment. Thus, a payment to or with respect to a

---

<sup>207</sup> S. Rep. 91-552, 91<sup>st</sup> Cong, 1<sup>st</sup> Sess., 273-74 (1969), referring to *Tank Truck Rentals, Inc. v. Commissioner*, 356 U.S. 30 (1958).

<sup>208</sup> The proposal provides that such amounts are nondeductible under chapter 1 of the Internal Revenue Code.

<sup>209</sup> The proposal does not affect the treatment of antitrust payments made under section 4 of the Clayton Act, which will continue to be governed by the provisions of section 162(g).

class broader than the specific persons or property that were actually harmed (e.g., to a class including similarly situated persons or property) does not qualify as restitution.<sup>210</sup> Restitution is limited to the amount that bears a substantial quantitative relationship to the harm caused by the past conduct or actions of the taxpayer that resulted in the payment in question. If the party harmed is a government or other entity, then restitution includes payment to such harmed government or entity, provided the payment bears a substantial quantitative relationship to the harm. However, restitution does not include reimbursement of government investigative or litigation costs, or payments to whistleblowers.

Amounts paid or incurred to, or at the direction of, any self-regulatory entity that regulates a financial market or other market that is a qualified board or exchange under section 1256(g)(7), and that is authorized to impose sanctions (e.g., the National Association of Securities Dealers) are subject to the proposal. To the extent provided in regulations, amounts paid or incurred to, or at the direction of, any other nongovernmental entity that exercises self-regulatory powers as part of performing an essential governmental function are also subject to the provision.

No inference is intended as to the treatment of payments as nondeductible fines or penalties under present law. In particular, the bill is not intended to limit the scope of present-law section 162(f) or the regulations thereunder.

#### **Effective Date**

The proposal is effective for amounts paid or incurred on or after April 28, 2003; however the proposal does not apply to amounts paid or incurred under any binding order or agreement entered into before such date. Any order or agreement requiring court approval is not a binding order or agreement for this purpose unless such approval was obtained on or before April 27, 2003.

---

<sup>210</sup> Similarly, a payment to a charitable organization benefitting a broader class than the persons or property actually harmed, or to be paid out without a substantial quantitative relationship to the harm caused, would not qualify as restitution. Under the proposal, such a payment not deductible under section 162 would also not be deductible under section 170.



## **R. Deposits Made to Suspend the Running of Interest on Potential Underpayments**

### **Present Law**

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

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

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

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

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

### **Description of Proposal**

#### **In general**

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

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

### **Use of a deposit to offset underpayments of tax**

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

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

### **Withdrawal of amounts**

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

For example, assume a calendar year individual taxpayer receives a 30-day letter showing a deficiency of \$20,000 for taxable year 2004 and deposits \$20,000 on May 15, 2006. On April 15, 2007, an administrative appeal is completed, and the taxpayer and the IRS agree that the 2004 taxes were underpaid by \$15,000. \$15,000 of the deposit is used to pay the underpayment. In this case, the taxpayer will owe underpayment interest from April 15, 2005 (the original due date of the return) to May 15, 2006, the date the \$20,000 was deposited. Simultaneously with the use of the \$15,000 to offset the underpayment, the taxpayer requests the return of the remaining amount of the deposit (after reduction for the underpayment interest owed by the taxpayer from April 15, 2005, to May 15, 2006). This amount must be returned to the taxpayer

with interest determined at the short-term applicable Federal rate from the May 15, 2006, to a date not more than 30 days preceding the date of the check repaying the deposit to the taxpayer.

### **Limitation on amounts for which interest may be allowed**

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

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

### **Deposits are not payments of tax**

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

### **Effective Date**

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

## **S. Clarification of Rules For Payment of Estimated Tax for Certain Deemed Asset Sales**

### **Present Law**

In certain circumstances, taxpayers can make an election under section 338(h)(10) to treat a qualifying purchase of 80 percent of the stock of a target corporation by a corporation from a corporation that is a member of an affiliated group (or a qualifying purchase of 80 percent of the stock of an S corporation by a corporation from S corporation shareholders) as a sale of the assets of the target corporation, rather than as a stock sale. The election must be made jointly by the buyer and seller of the stock and is due by the 15<sup>th</sup> day of the ninth month beginning after the month in which the acquisition date occurs. An agreement for the purchase and sale of stock often may contain an agreement of the parties to make a section 338(h)(10) election.

Section 338(a) also permits a unilateral election by a buyer corporation to treat a qualified stock purchase of a corporation as a deemed asset acquisition, whether or not the seller of the stock is a corporation (or an S corporation is the target). In such a case, the seller or sellers recognize gain or loss on the stock sale (including any estimated taxes with respect to the stock sale), and the target corporation recognizes gain or loss on the deemed asset sale.

Section 338(h)(13) provides that, for purposes of section 6655 (relating to additions to tax for failure by a corporation to pay estimated income tax), tax attributable to a deemed asset sale under section 338(a)(1) shall not be taken into account. Some taxpayers may be taking the position that this exception applies to a section 338(h)(10) election and that when such an election is made, neither any stock sale nor any asset sale needs to be taken into account for estimated tax purposes.

### **Description of Proposal**

The proposal would clarify section 338(h)(13) to provide that the exception for estimated tax purposes with respect to tax attributable to a deemed asset sale does not apply with respect to a qualified stock purchase for which an election is made under section 338(h)(10).

Under the proposal, if a transaction eligible for the election under section 338(h)(10) occurs, estimated tax would be determined based on the stock sale unless and until there is an agreement of the parties to make a section 338(h)(10) election.

If at the time of the sale there is an agreement of the parties to make a section 338(h)(10) election, then estimated tax would be computed based on an asset sale. If the agreement to make a section 338(h)(10) election is concluded after the stock sale, such that the original computation was based on a stock sale, estimated tax would be recomputed based on the asset sale election.

No inference is intended as to present law.

### **Effective Date**

The proposal would be effective for transactions that occur after the date of enactment of the proposal.

## **T. Limit Deduction for Charitable Contributions of Patents and Similar Property**

### **Present Law**

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization.<sup>211</sup> The amount of deduction generally equals the fair market value of the contributed cash or property on the date of the contribution.

For certain contributions of property, the taxpayer is required to reduce the deduction amount by any gain, generally resulting in a deduction equal to the taxpayer's basis. This rule applies to contributions of: (1) property that, at the time of contribution, would have resulted in short-term capital gain if the property was sold by the taxpayer on the contribution date; (2) tangible personal property that is used by the donee in a manner unrelated to the donee's exempt (or governmental) purpose; and (3) property to or for the use of a private foundation (other than a foundation defined in section 170(b)(1)(E)).

Charitable contributions of capital gain property generally are deductible at fair market value. Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property are subject to different percentage limitations than other contributions of property.

### **Description of Proposal**

The proposal provides that the amount of the deduction for charitable contributions of patents or similar property (for example, patent applications, copyrights, trade names, trade secrets, trademarks) is limited to the lesser of the taxpayer's basis in the contributed property or the fair market value of the contributed property (determined at the time of the contribution). The proposal applies to direct transfers of a patent or similar property to a qualified charity and to indirect transfers or other arrangements that are intended to disguise the contribution of a patent as a contribution of other property or otherwise to circumvent the rule of the proposal.

### **Effective Date**

The proposal would be effective for contributions of patents and similar property made after May 7, 2003.

---

<sup>211</sup> Charitable deductions are provided for income, estate, and gift tax purposes. Secs. 170, 2055, and 2522, respectively.

## **U. Temporary State Fiscal Relief Fund**

### **Description of Proposal**

The proposal establishes a fund to provide \$20 billion, equally divided among State and local governments, to be used for education or job training; health care services, including Medicaid; transportation or other infrastructure; law enforcement or public safety; and other essential government services.

## **V. Extension of Customs User Fees**

### **Present Law**

The Border and Transportation Security Directorate of the Department of Homeland Security collect nine different conveyance and passenger user fees and a merchandise processing fee. All of these fees expire after September 30, 2003.

### **Description of Proposal**

The proposal extends the conveyance and passenger user fees and merchandise processing fee through December 31, 2013.

### **Effective Date**

The proposal is effective on the date of enactment.



## **W. SSI Redetermination**

### **Description of Proposal**

This offset would align the initial review requirements for Title XVI with those currently required under Title II. As under Title II, the Commissioner of Social Security would be required to review initial Title XVI SSI blindness and disability determinations made by agencies in advance of awarding payments.

For FY 2004, the SSI review would be required for 25 percent of all State-determined allowances. In FY 2005 and thereafter, review would be required for at least 50 percent of state-determined allowances. To the extent feasible, this offset would require that the Commissioner select for review the determinations most likely to be incorrect.

## **X. Covering Childless Adults with SCHIP Funds**

### **Present Law**

In 1997, when the State Children Health Insurance Program (“SCHIP”) was created, Congress specified that SCHIP allocations only could be used, “to enable [States] to initiate and expand the provision of child health assistance to uninsured, low-income children in an effective and efficient manner.” The use of funds dedicated by Congress to low-income uninsured children on childless adults is an inappropriate implementation of the SCHIP statute.

### **Description of Proposal**

In the past, the Secretary of Health and Human Services has approved waivers that spend SCHIP dollars to cover childless adults. The proposal clarifies the intent of Congress; specifically stating that SCHIP funds cannot be spent on childless adults. It will no longer be legal for the Secretary to approve a waiver providing health insurance coverage through SCHIP to childless adults.