108th Congress) (S. PRT.
1st Session) COMMITTEE PRINT (108-__

JOBS AND GROWTH RECONCILIATION TAX ACT OF 2003

TECHNICAL EXPLANATION OF PROVISIONS APPROVED
BY THE COMMITTEE ON MAY 8, 2003

COMMITTEE ON FINANCE
UNITED STATES SENATE

Charles E. Grassley, *Chairman*

May 2003

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A. Accelerate Reductions in Individual Income Tax Rates (secs. 101, 102 and 103 of the bill and secs. 1 and 55 of the Code)

Present Law

In general

Under the Federal individual income tax system, an individual who is a citizen or a resident of the United States generally is subject to tax on worldwide taxable income. Taxable income is total gross income less certain exclusions, exemptions, and deductions. An individual may claim either a standard deduction or itemized deductions.

An individual's income tax liability is determined by computing his or her regular income tax liability and, if applicable, alternative minimum tax liability.

Regular income tax liability

Regular income tax liability is determined by applying the regular income tax rate schedules (or tax tables) to the individual's taxable income. This tax liability is then reduced by any applicable tax credits. The regular income tax rate schedules are divided into several ranges of income, known as income brackets, and the marginal tax rate increases as the individual's income increases. The income bracket amounts are adjusted annually for inflation. Separate rate schedules apply based on filing status: single individuals (other than heads of households and surviving spouses), heads of households, married individuals filing joint returns (including surviving spouses), married individuals filing separate returns, and estates and trusts. Lower rates may apply to capital gains.

For 2003, the regular income tax rate schedules for individuals are shown in Table 1, below. The rate bracket breakpoints for married individuals filing separate returns are exactly one-half of the rate brackets for married individuals filing joint returns. A separate, compressed rate schedule applies to estates and trusts.

Table 1.–Individual Regular Income Tax Rates for 2003

If taxable income is over:	But not over:	Then regular income tax equals:
	Single Individuals	
$0	$6,000	10% of taxable income
$6,000....................................	$28,400	$600, plus 15% of the amount over $6,000
$28,400.................................	$68,800	$3,960.00, plus 27% of the amount over $28,400
$68,800.................................	$143,500	$14,868.00, plus 30% of the amount over $68,800
$143,500...............................	$311,950	$37,278.00, plus 35% of the amount over $143,500
Over 311,950..........................		$96,235.50, plus 38.6% of the amount over $311,950
	Head of Households	
$0	$10,000	10% of taxable income
$10,000.................................	$38,050	$1,000, plus 15% of the amount over $10,000
$38,050.................................	$98,250	$5,207.50, plus 27% of the amount over $38,050
$98,250.................................	$159,100	$21,461.50, plus 30% of the amount over $98,250
$159,100...............................	$311,950	$39,716.50, plus 35% of the amount over $159,100
Over 311,950..........................		$93,214, plus 38.6% of the amount over $311,950
	Married Individuals Filing Joint Returns	
$0	$12,000	10% of taxable income
$12,000.................................	$47,450	$1,200, plus 15% of the amount over $12,000
$47,450.................................	$114,650	$6,517.50, plus 27% of the amount over $47,450
$114,650...............................	$174,700	$24,661.50, plus 30% of the amount over $114,650
$174,700...............................	$311,950	$42,676.50, plus 35% of the amount over $174,700
Over 311,950..........................		$90,714, plus 38.6% of the amount over $311,950

<u>Ten-percent regular income tax rate</u>

Under present law, the 10-percent rate applies to the first $6,000 of taxable income for single individuals, $10,000 of taxable income for heads of households, and $12,000 for married couples filing joint returns. Effective beginning in 2008, the $6,000 amount will increase to $7,000 and the $12,000 amount will increase to $14,000.

The taxable income levels for the 10-percent rate bracket will be adjusted annually for inflation for taxable years beginning after December 31, 2008. The bracket for single individuals and married individuals filing separately is one-half for joint returns (after adjustment of that bracket for inflation).

The 10-percent rate bracket will expire for taxable years beginning after December 31, 2010, under the sunset provision of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA").

<u>Reduction of other regular income tax rates</u>

Prior to EGTRRA, the regular income tax rates were 15 percent, 28 percent, 31 percent, 36 percent, and 39.6 percent.[1] EGTRRA added the 10-percent regular income tax rate, described above, and retained the 15-percent regular income tax rate. Also, the 15-percent regular income tax bracket was modified to begin at the end of the 10-percent regular income tax bracket. EGTRRA also made other changes to the 15-percent regular income tax bracket.[2]

Also, under EGTRRA, the 28 percent, 31 percent, 36 percent, and 39.6 percent rates are phased down over six years to 25 percent, 28 percent, 33 percent, and 35 percent, effective after June 30, 2001. The taxable income levels for the rates above the 15-percent rate in all taxable years are the same as the taxable income levels that apply under the prior-law rates.

Table 2, below, shows the schedule of regular income tax rate reductions.

Table 2.–Scheduled Regular Income Tax Rate Reductions

Taxable Year	28% rate reduced to:	31% rate reduced to:	36% rate reduced to:	39.6% rate reduced to:
2001[1]-2003	27%	30%	35%	38.6%
2004-2005	26%	29%	34%	37.6%
2006 thru 2010[2]	25%	28%	33%	35.0%

[1] Effective July 1, 2001.

[2] The reduction in the regular income tax rates are repealed for taxable years beginning after December 31, 2010, under the sunset provision of EGTRRA.

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[1] The regular income tax rates will revert to these percentages for taxable years beginning after December 31, 2010, under the sunset of EGTRRA.

[2] See the discussion of the provision regarding marriage penalty relief in the 15-percent regular income tax bracket, below.

Alternative minimum tax

The alternative minimum tax is the amount by which the tentative minimum tax exceeds the regular income tax. An individual's tentative minimum tax is an amount equal to (1) 26 percent of the first $175,000 ($87,500 in the case of a married individual filing a separate return) of alternative minimum taxable income ("AMTI") in excess of a phased-out exemption amount and (2) 28 percent of the remaining AMTI. The maximum tax rates on net capital gain used in computing the tentative minimum tax are the same as under the regular tax. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments. The exemption amounts are: (1) $49,000 ($45,000 in taxable years beginning after 2004) in the case of married individuals filing a joint return and surviving spouses; (2) $35,750 ($33,750 in taxable years beginning after 2004) in the case of other unmarried individuals; (3) $24,500 ($22,500 in taxable years beginning after 2004) in the case of married individuals filing a separate return; and (4) $22,500 in the case of an estate or trust. The exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) $150,000 in the case of married individuals filing a joint return and surviving spouses, (2) $112,500 in the case of other unmarried individuals, and (3) $75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

Reasons for Change

The Committee believes that high marginal individual income tax rates reduce incentives for taxpayers to work, to save, and to invest and, thereby, have a negative effect on the long-term health of the economy. The higher that marginal tax rates are, the greater is the disincentive for individuals to increase their work effort. Lower marginal tax rates provide greater incentives to taxpayers to be entrepreneurial risk takers; the Committee believes that the higher marginal tax rates of prior-law discourage success. The Committee believes that this tax cut will lead to increased investment by these businesses, promoting long-term growth and stability in the economy and rewarding the businessmen and women who provide a foundation for our country's success.

In addition, lower marginal tax rates help remove the barriers that lower-income families face as they try to enter the middle class. The lower the marginal tax rates for lower-income families, the greater is the incentive to work. The expanded 10-percent rate bracket provides an incentive for these taxpayers to increase their work effort.

Finally, there are signs that the economy is not growing as fast as desirable. The Committee believes that immediate tax relief could encourage growth in the economy by providing individuals with additional tax relief. The Committee recognizes that it is important to act quickly so that taxpayers are aware of the commitment of the President and the Congress to enact this tax cut and to adjust income tax withholding tables.

Explanation of Provision

Ten-percent regular income tax rate

The bill accelerates the scheduled increase in the taxable income levels for the 10-percent rate bracket. Specifically, beginning in 2003, the bill increases the taxable income level for the 10-percent regular income tax rate brackets for single individuals from $6,000 to $7,000 and for married individuals filing jointly from $12,000 to $14,000. The taxable income levels for the 10-percent regular income tax rate bracket will be adjusted annually for inflation for taxable years beginning after December 31, 2003.

Reduction of other regular income tax rates

The bill accelerates the reductions in the regular income tax rates in excess of the 15-percent regular income tax rate that are scheduled for 2004 and 2006. Therefore, for 2003 and thereafter, the regular income tax rates in excess of 15 percent under the bill are 25 percent, 28 percent, 33 percent, and 35 percent.

Alternative minimum tax exemption amounts

The bill 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.

Effective Date

The provision is effective for taxable years beginning after December 31, 2002.

B. Accelerate Marriage Penalty Relief
(secs. 104 and 105 of the bill and secs. 1 and 63 of the Code)

1. Standard deduction marriage penalty relief

Present Law

Marriage penalty

A married couple generally is treated as one tax unit that must pay tax on the couple's total taxable income. Although married couples may elect to file separate returns, the rate schedules and other provisions are structured so that filing separate returns usually results in a higher tax than filing a joint return. Other rate schedules apply to single persons and to single heads of households.

A "marriage penalty" exists when the combined tax liability of a married couple filing a joint return is greater than the sum of the tax liabilities of each individual computed as if they were not married. A "marriage bonus" exists when the combined tax liability of a married couple filing a joint return is less than the sum of the tax liabilities of each individual computed as if they were not married.

Basic standard deduction

Taxpayers who do not itemize deductions may choose the basic standard deduction (and additional standard deductions, if applicable),[3] which is subtracted from adjusted gross income ("AGI") in arriving at taxable income. The size of the basic standard deduction varies according to filing status and is adjusted annually for inflation.[4] For 2003, the basic standard deduction for married couples filing a joint return is 167 percent of the basic standard deduction for single filers. (Alternatively, the basic standard deduction amount for single filers is 60 percent of the basic standard deduction amount for married couples filing joint returns.) Thus, two unmarried individuals have standard deductions whose sum exceeds the standard deduction for a married couple filing a joint return.

EGTRRA increased the basic standard deduction for a married couple filing a joint return to twice the basic standard deduction for an unmarried individual filing a single return.[5] The increase in the standard deduction for married taxpayers filing a joint return is scheduled to be phased-in over five years beginning in 2005 and will be fully phased-in for 2009 and thereafter. Table 3, below, shows the standard deduction for married couples filing a joint return as a percentage of the standard deduction for single individuals during the phase-in period.

Table 3.–Scheduled Phase-In of Increase of the Basic Standard Deduction for Married Couples Filing Joint Returns

Taxable Year	Standard Deduction for Married Couples Filing Joint Returns as Percentage of Standard Deduction for Unmarried Individual Returns
2005	174
2006	184
2007	187
2008	190

[3] Additional standard deductions are allowed with respect to any individual who is elderly (age 65 or over) or blind.

[4] For 2003 the basic standard deduction amounts are: (1) $4,750 for unmarried individuals; (2) $7,950 for married individuals filing a joint return; (3) $7,000 for heads of households; and (4) $3,975 for married individuals filing separately.

[5] The basic standard deduction for a married taxpayer filing separately will continue to equal one-half of the basic standard deduction for a married couple filing jointly; thus, the basic standard deduction for unmarried individuals filing a single return and for married couples filing separately will be the same after the phase-in period.

2009 and 2010[1]	200

[1] The basic standard deduction increases are repealed for taxable years beginning after December 31, 2010, under the sunset provision of EGTRRA.

Reasons for Change

The Committee remains concerned about the inequity that arises when two working single individuals marry and experience a tax increase solely by reason of their marriage. Any attempt to address the marriage tax penalty involves the balancing of several competing principles, including equal tax treatment of married couples with equal incomes, the determination of equitable relative tax burdens of single individuals and married couples with equal incomes, and the goal of simplicity in compliance and administration. The Committee believes that the acceleration of the increase in the standard deduction for married couples filing a joint return is a responsible reduction of the marriage tax penalty.

Explanation of Provision

The bill accelerates the increase in the basic standard deduction amount for joint returns to twice the basic standard deduction amount for single returns effective for 2003.

Effective Date

The provision is effective for taxable years beginning after December 31, 2002.

2. Accelerate the expansion of the 15-percent rate bracket for married couples filing joint returns

Present Law

In general

Under the Federal individual income tax system, an individual who is a citizen or resident of the United States generally is subject to tax on worldwide taxable income. Taxable income is total gross income less certain exclusions, exemptions, and deductions. An individual may claim either a standard deduction or itemized deductions.

An individual's income tax liability is determined by computing his or her regular income tax liability and, if applicable, alternative minimum tax liability.

Regular income tax liability

Regular income tax liability is determined by applying the regular income tax rate schedules (or tax tables) to the individual's taxable income and then is reduced by any applicable tax credits. The regular income tax rate schedules are divided into several ranges of income, known as income brackets, and the marginal tax rate increases as the individual's income increases. The income bracket amounts are adjusted annually for inflation. Separate rate schedules apply based on filing status: single individuals (other than heads of households and surviving spouses), heads of households, married individuals filing joint returns (including surviving spouses), married individuals filing separate returns, and estates and trusts. Lower rates may apply to capital gains.

In general, the bracket breakpoints for single individuals are approximately 60 percent of the rate bracket breakpoints for married couples filing joint returns.[6] The rate bracket breakpoints for married individuals filing separate returns are exactly one-half of the rate brackets for married individuals filing joint returns. A separate, compressed rate schedule applies to estates and trusts.

15-percent regular income tax rate bracket

EGTRRA increased the size of the 15-percent regular income tax rate bracket for a married couple filing a joint return to twice the size of the corresponding rate bracket for a single individual filing a single return. The increase is phased-in over four years, beginning in 2005. Therefore, this provision is fully effective (i.e., the size of the 15-percent regular income tax rate bracket for a married couple filing a joint return is twice the size of the 15-percent regular income tax rate bracket for an unmarried individual filing a single return) for taxable years beginning after December 31, 2007. Table 4, below, shows the increase in the size of the 15-percent bracket during the phase-in period.

Table 4.–Scheduled Increase in Size of the 15-Percent Rate Bracket for Married Couples Filing Joint Returns

Taxable year	End Point of 15-Percent Rate Bracket for Married Couples Filing Joint Returns as Percentage of End Point of 15-Percent Rate Bracket for Unmarried Individuals
2005	180
2006	187
2007	193
2008 through 2010[1]	200

[1] The increases in the 15-percent rate bracket for married couples filing a joint return are repealed for taxable years beginning after December 31, 2010, under the sunset of EGTRRA.

Reasons for Change

The Committee believes that accelerating the expansion of the 15-percent rate bracket for married couples filing joint returns, in conjunction with the expansion of the standard deduction

[6] Under present law, the rate bracket breakpoint for the 38.6 percent marginal tax rate is the same for single individuals and married couples filing joint returns.

amount for joint filers, will alleviate the effects of the present-law marriage tax penalty. These provisions significantly reduce the most widely applicable marriage penalties.

Explanation of Provision

The bill accelerates the increase of the size of the 15-percent regular income tax rate bracket for joint returns to twice the width of the 15-percent regular income tax rate bracket for single returns beginning in 2003.

Effective Date

The provision is effective for taxable years beginning after December 31, 2002.

C. Accelerate the Increase in the Child Tax Credit (sec. 106 of the bill and sec. 24 of the Code)

Present Law

In general

For 2003, an individual may claim a $600 tax credit for each qualifying child under the age of 17. In general, a qualifying child is an individual for whom the taxpayer can claim a dependency exemption and who is the taxpayer's son or daughter (or descendent of either), stepson or stepdaughter (or descendent of either), or eligible foster child.

The child tax credit is scheduled to increase to $1,000, phased-in over several years.

Table 5, below, shows the scheduled increases of the child tax credit.

Table 5.–Scheduled Increase of the Child Tax Credit

Taxable Year	Credit Amount Per Child
2003-2004	$600
2005-2008	$700
2009	$800
2010[1]	$1,000

[1] The credit reverts to $500 in taxable years beginning after December 31, 2010, under the sunset provision of EGTRRA.

The child tax credit is phased-out for individuals with income over certain thresholds. Specifically, the otherwise allowable child tax credit is reduced by $50 for each $1,000 (or fraction thereof) of modified adjusted gross income over $75,000 for single individuals or heads of households, $110,000 for married individuals filing joint returns, and $55,000 for married individuals filing separate returns.[7] The length of the phase-out range depends on the number of qualifying children. For example, the phase-out range for a single individual with one qualifying child is between $75,000 and $87,000 of modified adjusted gross income. The phase-out range for a single individual with two qualifying children is between $75,000 and $99,000.

The amount of the tax credit and the phase-out ranges are not adjusted annually for inflation.

Refundability

For 2003, the child credit is refundable to the extent of 10 percent of the taxpayer's earned income in excess of $10,500.[8] The percentage is increased to 15 percent for taxable years 2005 and thereafter. Families with three or more children are allowed a refundable credit for the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income credit, if that amount is greater than the refundable credit based on the taxpayer's earned income in excess of $10,500 (for 2003). The refundable portion of the child credit does not constitute income and is not treated as resources for purposes of determining eligibility or the amount or nature of benefits or assistance under any Federal program or any State or local program financed with Federal funds. For taxable years beginning after December 31, 2010, the sunset provision of EGTRRA applies to the rules allowing refundable child credits.

Alternative minimum tax liability

The child credit is allowed against the individual's regular income tax and alternative minimum tax. For taxable years beginning after December 31, 2010, the sunset provision of EGTRRA applies to the rules allowing the child credit against the alternative minimum tax.

Reasons for Change

This provision accelerates the increase in the child tax credit, and accelerates the increase in the refundable portion of the credit, in order to provide additional tax relief to families to help offset the significant costs of raising a child. Further, the bill provides immediate tax relief to American taxpayers in the form of the advance payment of the increased amount of the child credit. The Committee believes that such immediate tax relief may encourage short-term growth in the economy by providing individuals with additional cash to spend.

Explanation of Provision

The amount of the child credit is increased to $1,000 for 2003 and thereafter. For 2003, the increased amount of the child credit will be paid in advance beginning in July 2003 on the

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[7] Modified adjusted gross income is the taxpayer's total gross income plus certain amounts excluded from gross income (i.e., excluded income of U.S. citizens or residents living abroad (sec. 911); residents of Guam, American Samoa, and the Northern Mariana Islands (sec. 931); and residents of Puerto Rico (sec. 933)).

[8] The $10,500 amount is indexed for inflation.

basis of information on each taxpayer's 2002 return filed in 2003. Advance payments will be made in a similar manner to the advance payment checks issued by the Treasury in 2001 to reflect the creation of the 10-percent regular income tax rate bracket. The increase in the refundable portion of the credit from 10 percent to 15 percent of the taxpayer's earned income in excess of the threshold amount is accelerated to 2003 from 2005.

Effective Date

The provision is effective for taxable years beginning after December 31, 2002.

D. Increase Section 179 Expensing
(sec. 107 of the bill and sec. 179 of the Code)

Present Law

Present law provides that, in lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $25,000 (for taxable years beginning in 2003 and thereafter) of the cost of qualifying property placed in service for the taxable year (sec. 179).[9] In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. An election to expense these items generally is made on the taxpayer's original return for the taxable year to which the election relates, and may be revoked only with the consent of the Commissioner.[10] In general, taxpayers may not elect to expense off-the-shelf computer software.[11]

The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations). No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179.

Reasons for Change

The Committee believes that section 179 expensing provides two important benefits for small business. First, it lowers the cost of capital for tangible property used in a trade or business. With a lower cost of capital, the Committee believes small business will invest in more

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[9] Additional section 179 incentives are provided with respect to a qualified property used by a business in the New York Liberty Zone (sec. 1400(f)) or an empowerment zone (sec. 1397A).

[10] Section 179(c)(2).

[11] Section 179(d)(1) requires that property be tangible to be eligible for expensing; in general, computer software is intangible property.

equipment and employ more workers. Second, it eliminates depreciation recordkeeping requirements with respect to expensed property. In order to increase the value of these benefits and to increase the number of taxpayers eligible, the Committee bill increases the amount allowed to be expensed under section 179 and increases the amount of the phaseout threshold, as well as indexing these amounts.

The Committee also believes that purchased computer software should be included in the section 179 expensing provision so that it is not disadvantaged relative to developed software. In addition, the Committee believes that the process of making and revoking section 179 elections should be made simpler and more efficient for taxpayers by eliminating the requirement of the consent of the Commissioner.

Explanation of Provision

The provision provides that the maximum dollar amount that may be deducted under section 179 is increased to $75,000 for property placed in service in 2003 and thereafter. In addition, the $200,000 amount is increased to $325,000 for property placed in service in 2003 and thereafter. Both of these dollar limitations are indexed annually for inflation after 2003. The provision also includes off-the-shelf computer software as qualifying property. The provision permits taxpayers to make or revoke expensing elections on amended returns without the consent of the Commissioner.

Effective Date

The provision is effective for taxable years beginning after December 31, 2002, and before January 1, 2013.

TITLE II – PARTIAL EXCLUSION OF DIVIDENDS

A. Partial Exclusion of Dividend Income from Tax (sec. 201 of the bill and sec. 116 of the Code)

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.[12]

Reasons for Change

The Committee believes it is important that tax policy be conducive to economic growth. Economic growth is impeded by tax-induced distortions in the capital markets. Mitigating these distortions will improve the efficiency of the capital markets. In addition, reducing the aggregate tax burden on investments made by corporations will lower the cost of capital needed to finance new investments and lead to increases in aggregate national investment by the private sector. It is through such investment that the United States' economy can increase output and productivity. It is through increases in productivity that workers earn higher real wages and all Americans benefit from a higher standard of living.

The Committee observes, that under present law, the magnitude of the total tax burden on income differs across different investments. The Committee believes that, by placing different tax burdens on different investments, the present system results in economic distortions. The Committee observes that present law distorts corporate financial decisions. The Committee observes that because interest payments on the debt are deductible, present law encourages corporations to finance using debt rather than equity and creates incentives for financial engineering to achieve interest deductions from financial instruments with substantial equity characteristics. The Committee believes that the increase in corporate leverage, while beneficial to each corporation from a tax perspective, may place the economy at risk of more bankruptcies during an economic downturn.

In addition, the Committee finds that present law encourages corporations to retain earnings rather than to distribute them as taxable dividends. If dividends are discouraged, shareholders may prefer that corporate management retain and reinvest earnings rather than pay out dividends, even if the shareholder might have an alternative use for the funds that could offer a higher rate of return than that earned on the retained earnings. This is another source of inefficiency as the opportunity to earn higher pre-tax returns is by-passed in favor of lower pre-tax returns.

Lastly, the Committee believes that if the fiscal position of the Federal government does not permit the Congress to completly eliminate the distortions described above, that it is appropriate to first reduce the tax burdens on the dividends of the smallest investors. The Committee believes that providing a 100-percent exemption for the first $500 of qualified

[12] Section 102 of the bill reduces the maximum rate to 35 percent.

dividend income will eliminate the taxation of such dividends for the vast majority of taxpayers and provide a further incentive to save to many lower and middle income taxpayers.

Explanation of Provision

Under the provision, an individual may exclude from gross income in a taxable year an amount equal to $500 ($250 in the case of a married individual filing a separate return) [13] of dividends received with respect to stock of a domestic corporation, and stock of a foreign corporation which is regularly tradable on an established securities market, plus 10 percent (20 percent in the case of taxable years beginning after December 31, 2007) of the dividends received in excess of these amounts.[14]

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)), [15] 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; deductible dividends paid on employer securities; or dividends received from a foreign corporation that was a foreign investment company (a defined in section 1246(b)), a passive foreign investment company (as defined in section 1297), or a passive foreign investment company (as defined in section 552) in either the taxable year of the distribution or the preceding taxable year.

[13] The $500 amount applies to a joint return.

[14] Payments in lieu of dividends are not eligible for the exclusion. See section 6045(d) relating to statements required to be furnished by brokers regarding these payments.

[15] In the case of preferred stock, the periods are doubled.

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.

No foreign tax credit is allowable with respect to dividends excluded under this provision.

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.[16] 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 exclusion.

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

Effective Date

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

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[16] These provisions include sections 86, 135, 137, 219, 221, 222, 408A, 469, 530, and the nonrefundable personal credits.

TITLE III – REVENUE PROVISIONS

SUBTITLE A – PROVISIONS DESIGNED TO CURTAIL TAX SHELTERS

A. Clarification of the economic substance doctrine (sec. 301 of the bill and sec. 7701 of the Code)

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.[17]

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.[18]

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:

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[17] *See, e.g., ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *aff'g* 73 T.C.M. (CCH) 2189 (1997), *cert. denied* 526 U.S. 1017 (1999).

[18] 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.[19]

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.[20]

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.[21] 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).[22] A third approach regards economic substance and business purpose as "simply

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[19] *ACM Partnership v. Commissioner*, 73 T.C.M. at 2215.

[20] *ACM Partnership v. Commissioner*, 157 F.3d at 256 n.48.

[21] *See, e.g., Pasternak v. Commissioner*, 990 F.2d 893, 898 (6th 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.")

[22] *See, e.g., Rice's Toyota World v. Commissioner*, 752 F.2d 89, 91-92 (4th 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 (8th 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.[23]

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.[24] 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.[25] 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.[26] In these cases, in assessing whether a

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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.

[23] *See, e.g., ACM Partnership v. Commissioner,* 157 F.3d at 247; *James v. Commissioner*, 899 F.2d 905, 908 (10th Cir. 1995); *Sacks v. Commissioner*, 69 F.3d 982, 985 (9th 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'.").

[24] *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).

[25] *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").

[26] *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.

Reasons for Change

The Committee is concerned that many taxpayers are engaging in tax avoidance transactions that rely on the interaction of highly technical tax law provisions. These transactions usually produce surprising results that were not contemplated by Congress. Whether these transactions are respected usually hinges on whether the transaction had sufficient economic substance. The Committee is concerned that in addressing these transactions the courts, in some cases, are reaching conclusions inconsistent with Congressional intent. In addition, the Committee is concerned that in determining whether a transaction has economic substance, taxpayers are subject to different legal standards based on the circuit that the taxpayer is located. Thus, the Committee believes it is appropriate to clarify for the courts the appropriate standards to use in determining whether a transaction has economic substance.

Explanation of Provision

In general

The provision clarifies and enhances the application of the economic substance doctrine. The provision 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.[27]

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

Conjunctive analysis

The provision 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 provision, 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

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[27] 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 provision.

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 provision 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 for the transaction must bear a reasonable relationship to the taxpayer's normal business operations or investment activities.[28]

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 if the origin of such financial accounting benefit is a reduction of income tax. 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)[29] should not be considered to have a substantial non-tax purpose unless a substantial non-tax purpose exists apart from the financial accounting benefits.[30]

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[28] *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.").

[29] 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.

[30] 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), *aff'd* by 2003 Fed. App. para. 0125 (CCH) (6th Cir. 2003) ("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)).

By requiring that a transaction be a "reasonable means" of accomplishing its non-tax purpose, the provision 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.

Profit potential

Under the provision, 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 provision 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.[31] 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.[32] 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 provision to the extent it meets the present law standards.

Transactions with tax-indifferent parties

The provision 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.

[31] Thus, a "reasonable possibility of profit" will not be sufficient to establish that a transaction has economic substance.

[32] 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.

Other rules

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

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 provision shall not be construed as altering or supplanting any other common law doctrine (including the sham transaction doctrine), and this provision shall be construed as being additive to any such other doctrine.

Effective Date

The provision applies to transactions entered into on or after May 8, 2003.

B. Penalty for Failure to Disclose Reportable Transactions (sec. 302 of the bill and sec. 6707A the Code)

Present Law

Regulations under section 6011 require a taxpayer to disclose with its tax return certain information with respect to each "reportable transaction" in which the taxpayer participates.[33]

There are six categories of reportable transactions. The first category is any transaction that is the same as (or substantially similar to)[34] 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").[35]

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

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[33] 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.

[34] 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).

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

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).[36]

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.[37]

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.[38]

The fifth category of reportable transactions refers to any transaction done by certain taxpayers[39] 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.[40]

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.[41]

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

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

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

[38] 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.

[39] 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.

[40] 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.

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

tax understatement attributable to such undisclosed transaction is due to reasonable cause, and that the taxpayer acted in good faith.[42]

Reasons for Change

The Committee is aware that individuals and corporations are increasingly using sophisticated transactions to avoid or evade Federal income tax.[43] Such a phenomenon could pose a serious threat to the efficacy of the tax system because of both the potential loss of revenue and the potential threat to the integrity of the self-assessment system.

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

Explanation of Provision

In general

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

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[42] 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.

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

Transactions to be disclosed

The provision does not define the terms "listed transaction"[44] or "reportable transaction," nor does the provision explain the type of information that must be disclosed in order to avoid the imposition of a penalty. Rather, the provision authorizes the Treasury Department to define a "listed transaction" and a "reportable transaction" under section 6011.

Penalty rate

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

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

A public entity that is required to pay a penalty for failing to disclose a listed transaction (or is subject to an understatement penalty attributable to a non-disclosed listed transaction, a non-disclosed reportable avoidance transaction,[45] or a transaction that lacks economic substance) must disclose the imposition of the penalty in reports to the Securities and Exchange

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

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

Commission for such period as the Secretary shall specify. The provision 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 provision is effective for returns and statements the due date for which is after the date of enactment.

C. Modifications to the Accuracy-Related Penalties for Listed Transactions and Reportable Transactions Having a Significant Tax Avoidance Purpose (sec. 303 of the bill and sec. 6662A of the Code)

Present Law

The accuracy-related penalty applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of corporations), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.[46] 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.[47]

Special rules apply with respect to tax shelters.[48] For understatements by non-corporate taxpayers attributable to tax shelters, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for the position, the taxpayer reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters.

The understatement penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was "reasonable cause" for the underpayment and that the taxpayer acted in good faith.[49] The relevant regulations provide that reasonable

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[46] Sec. 6662.

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

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

[49] Sec. 6664(c).

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.[50]

Reasons for Change

Because the Treasury shelter initiative emphasizes combating abusive tax avoidance transactions by requiring increased disclosure of such transactions by all parties involved, the Committee believes that taxpayers should be subject to a strict liability penalty on an understatement of tax that is attributable to non-disclosed listed transactions or non-disclosed reportable transactions that have a significant purpose of tax avoidance. Furthermore, in order to deter taxpayers from entering into tax avoidance transactions, the Committee believes that a more meaningful (but less stringent) accuracy-related penalty should apply to such transactions even when disclosed.

Explanation of Provision

In general

The provision modifies the present-law accuracy related penalty by replacing the rules applicable to tax shelters with a new accuracy-related penalty that applies to listed transactions and reportable transactions with a significant tax avoidance purpose (hereinafter referred to as a "reportable avoidance transaction").[51] 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.

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

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

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

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

Determination of the understatement amount

The penalty is applied to the amount of any understatement attributable to the listed or reportable avoidance transaction without regard to other items on the tax return. For purposes of this provision, the amount of the understatement is determined as the sum of (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return) [52], and (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item.

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

Strengthened reasonable cause exception

A penalty is not imposed under the provision with respect to any portion of an understatement if it shown that there was reasonable cause for such portion and the taxpayer acted in good faith. Such a showing requires (1) adequate disclosure of the facts affecting the transaction in accordance with the regulations under section 6011,[53] (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

[52] 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.

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

treated as having a reasonable belief with respect to the tax treatment of an item only if such belief (1) is based on the facts and law that exist at the time the tax return (that includes the item) is filed, and (2) relates solely to the taxpayer's chances of success on the merits and does not take into account the possibility that (a) a return will not be audited, (b) the treatment will not be raised on audit, or (c) the treatment will be resolved through settlement if raised.

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

Disqualified tax advisor

A disqualified tax advisor is any advisor who (1) is a material advisor[54] 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[55] 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.[56] Participation in the

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[54] 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).

[55] 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.

[56] 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

"management" of a transaction means involvement in the decision-making process regarding any business activity with respect to the transaction. Participation in the "promotion or sale" of a transaction means involvement in the marketing or solicitation of the transaction to others. Thus, an advisor who provides information about the transaction to a potential participant is involved in the promotion or sale of a transaction, as is any advisor who recommends the transaction to a potential participant.

Disqualified opinion

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

Coordination with other penalties

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

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

Effective Date

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

D. Penalty for Understatements From Transactions Lacking Economic Substance (sec. 304 of the bill and sec. 6662B of the Code)

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.[57] 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

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as determined by the Secretary, has a continuing financial interest with respect to the transaction).

[57] Sec. 6662.

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.[58] For understatements by non-corporate taxpayers attributable to tax shelters, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for the position, the taxpayer reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters.

The 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.[59] 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.[60]

<u>**Reasons for Change**</u>

The Committee is concerned that many taxpayers are engaging in tax avoidance transactions that rely on the interaction of highly technical tax law provisions. These transactions usually produce surprising results that were not contemplated by Congress. Whether these transactions are respected usually hinges on whether the transaction had sufficient economic substance. The Committee believes that the benefits that taxpayers potentially obtain from these transactions significantly outweigh the potential costs of engaging in such transactions. In addition, the Committee believes taxpayers will continue to engage in tax avoidance transactions until the risk and cost to the taxpayer of engaging in the transactions is increased. Thus, the Committee believes that taxpayers should be subject to the imposition of a substantial strict liability penalty for transactions that are determined not have economic substance.

<u>**Explanation of Provision**</u>

The provision 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").[61] 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

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

[59] Sec. 6664(c).

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

[61] Thus, unlike the new accuracy-related penalty under section 6662A (which applies only to listed and reportable avoidance transactions), the new penalty under this provision applies to any transaction that lacks economic substance.

6011). No exceptions (including the reasonable cause or rescission rules) to the penalty would be available under the provision (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 provision regarding the economic substance doctrine),[62] (2) the transaction was not respected under the rules relating to transactions with tax-indifferent parties (as described in the earlier provision regarding the economic substance doctrine),[63] 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 provision, the calculation of an "understatement" is made in the same manner as in the separate provision relating to accuracy-related penalties for listed and reportable avoidance transactions (new sec. 6662A). Thus, the amount of the understatement under this provision 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), [64] 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 provision (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

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[62] The provision 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.

[63] The provision provides that the form of a transaction that involves a tax-indifferent party will not be respected in certain circumstances.

[64] 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.

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 provision and the reasons for the compromise.

Any understatement to which a penalty is imposed under this provision 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 provision 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 provision will not apply to any portion of an understatement to which a fraud penalty is applied under section 6663.

Effective Date

The provision applies to transactions entered into on or after May 8, 2003.

E. Modifications to the Substantial Understatement Penalty (sec. 305 of the bill and sec. 6662of the Code)

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).[65]

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.[66]

[65] Sec. 6662(a) and (d)(1)(A).

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

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.[67]

Reasons for Change

The Committee believes that the present-law definition of substantial understatement allows large corporate taxpayers to avoid the accuracy-related penalty on questionable transactions of a significant size. The Committee believes that an understatement of more than $10 million is substantial in and of itself, regardless of the proportion it represents of the taxpayer's total tax liability.

The Committee believes that a higher compliance standard should be imposed on any taxpayer in order to reduce the amount of an understatement resulting from a transaction that the taxpayer did not adequately disclose. The Committee further believes that a taxpayer should not take a position on a tax return that could give rise to a substantial understatement penalty that the taxpayer does not believe is more likely than not the correct tax treatment unless this information is disclosed to the IRS.

Explanation of Provision

Definition of substantial understatement

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

Reduction of understatement for certain positions

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

[67] Sec. 6662(d)(2)(D).

F. Tax Shelter Exception to Confidentiality Privileges Relating to Taxpayer Communications (sec. 306 of the bill and sec. 7525 of the Code)

Present Law

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

Reasons for Change

The Committee believes that the rule currently applicable to corporate tax shelters should be applied to all tax shelters, regardless of whether or not the participant is a corporation.

Explanation of Provision

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

Effective Date

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

G. Disclosure of Reportable Transactions by Material Advisors (secs. 307 and 308 of the bill and secs. 6111 and 6707 of the Code)

Present Law

Registration of tax shelter arrangements

An organizer of a tax shelter is required to register the shelter with the Secretary not later than the day on which the shelter is first offered for sale.[68] A "tax shelter" means any investment with respect to which the tax shelter ratio[69] for any investor as of the close of any of the first five

[68] Sec. 6111(a).

[69] 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

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).[70]

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.[71]

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,"[72] 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.[73] Certain exceptions are provided with respect to the second category of transactions.[74]

An arrangement is offered under conditions of confidentiality if: (1) an offeree has an understanding or agreement to limit the disclosure of the transaction or any significant tax features of the transaction; or (2) the promoter knows, or has reason to know that the offeree's use or disclosure of information relating to the transaction is limited in any other manner.[75]

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.[76] However, if the tax shelter involves an

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to any investor, bears to the investment base (money plus basis of assets contributed) as of the close of the tax year.

[70] Sec. 6111(c).

[71] Sec. 6111(d).

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

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

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

[75] 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).

[76] Sec. 6707.

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

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

Reasons for Change

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

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

Explanation of Provision

Disclosure of reportable transactions by material advisors

The provision repeals the present law rules with respect to registration of tax shelters. Instead, the provision requires each material advisor with respect to any reportable transaction (including any listed transaction)[77] 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.[78]

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

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

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

$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 provision repeals the present law penalty for failure to register tax shelters. Instead, the provision imposes a penalty on any material advisor who fails to file an information return, or who files a false or incomplete information return, with respect to a reportable transaction (including a listed transaction).[79] 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.[80] All or part of the penalty may be rescinded only if: (1) the material advisor on whom the penalty is imposed has a history of complying with the Federal tax laws, (2) it is shown that the violation is due to an unintentional mistake of fact, (3) imposing the penalty would be against equity and good conscience, and (4) rescinding the penalty would promote compliance with the tax laws and effective tax administration. The authority to rescind the penalty can only be exercised by the Commissioner personally or the head of the Office of Tax Shelter Analysis; this authority to rescind cannot otherwise be delegated by the Commissioner. Thus, the penalty cannot be rescinded by a revenue agent, an Appeals officer, or other IRS personnel. The decision to rescind a penalty must be accompanied by a record describing the facts and reasons for the action and the amount rescinded. There will be no right to appeal a refusal to rescind a penalty. The IRS also is required to submit an annual report to Congress summarizing the application of the disclosure penalties and providing a description of each penalty rescinded under this provision and the reasons for the rescission.

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

[80] The Secretary's present-law authority to postpone certain tax-related deadlines because of Presidentially-declared disasters (sec. 7508A) will also encompass the authority to postpone the reporting deadlines established by the provision.

Effective Date

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

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

H. Investor Lists and Modification of Penalty for Failure to Maintain Investor Lists (secs. 307 and 309 of the bill and secs. 6112 and 6708 of the Code)

Present Law

Investor lists

Any organizer or seller of a potentially abusive tax shelter must maintain a list identifying each person who was sold an interest in any such tax shelter with respect to which registration was required under section 6111 (even though the particular party may not have been subject to confidentiality restrictions).[81] Recently issued regulations under section 6112 contain rules regarding the list maintenance requirements.[82] In general, the regulations apply to transactions that are potentially abusive tax shelters entered into, or acquired after, February 28, 2003.[83]

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.[84] 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.[85] For listed transactions (as defined in the regulations under section 6011), the minimum fees are reduced to $25,000 and $10,000, respectively.

A potentially abusive tax shelter is any transaction that (1) is required to be registered under section 6111, (2) is a listed transaction (as defined under the regulations under section 6011), or (3) any transaction that a potential material advisor, at the time the transaction is

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[81] Sec. 6112.

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

[83] 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.

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

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

entered into, knows is or reasonably expects will become a reportable transaction (as defined under the new regulations under section 6011).[86]

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.[87]

Penalty for failing to maintain investor lists

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

Reasons for Change

The Committee has been advised that the present-law penalties for failure to maintain customer lists are not meaningful and that promoters often have refused to provide requested information to the IRS. The Committee believes that requiring material advisors to maintain a list of advisees with respect to each reportable transaction, coupled with more meaningful penalties for failing to maintain an investor list, are important tools in the ongoing efforts to curb the use of abusive tax avoidance transactions.

Explanation of Provision

Investor lists

Each material advisor[88] with respect to a reportable transaction (including a listed transaction)[89] is required to maintain a list that (1) identifies each person with respect to whom the advisor acted as a material advisor with respect to the reportable transaction, and (2) contains other information as may be required by the Secretary. In addition, the provision authorizes (but does not require) the Secretary to prescribe regulations which provide that, in cases in which 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 provision modifies the penalty for failing to maintain the required list by making it a time-sensitive penalty. Thus, a material advisor who is required to maintain an investor list and

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

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

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

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

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.[90]

Effective Date

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

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

I. Actions to Enjoin Conduct with Respect to Tax Shelters and Reportable Transactions (sec. 310 of the bill and sec. 7408 of the Code)

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.[91]

Reasons for Change

The Committee understands that some promoters are blatantly ignoring the rules regarding registration and list maintenance regardless of the penalties. An injunction would place these promoters in a public proceeding under court order. Thus, the Committee believes that the types of tax shelter activities with respect to which an injunction may be sought should be expanded.

Explanation of Provision

The provision expands this rule so that injunctions may also be sought with respect to the requirements relating to the reporting of reportable transactions[92] and the keeping of lists of investors by material advisors.[93] Thus, under the provision, an injunction may be sought against a material advisor to enjoin the advisor from (1) failing to file an information return with respect

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

[91] Sec. 7408.

[92] Sec. 6707, as amended by other provisions of this bill.

[93] Sec. 6708, as amended by other provisions of this bill.

to a reportable transaction, or (2) failing to maintain, or to timely furnish upon written request by the Secretary, a list of investors with respect to each reportable transaction.

Effective Date

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

J. Understatement of Taxpayer's Liability by Income Tax Return Preparer (sec. 311 of the bill and sec. 6694 of the Code)

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.

Reasons for Change

The Committee believes that the standards of conduct applicable to income tax return preparers should be the same as the standards applicable to taxpayers. Accordingly, the minimum standard for each undisclosed position on a tax return would be that the preparer must reasonably believe that the tax treatment is more likely than not the proper tax treatment. The Committee believes that this standard is appropriate because the tax return is signed under penalties of perjury, which implies a high standard of diligence in determining the facts and substantial accuracy in determining and applying the rules that govern those facts. The Committee believes that it is both appropriate and vital to the tax system that both taxpayers and their return preparers file tax returns that they reasonably believe are more likely than not correct. In addition, conforming the standards of conduct applicable to income tax return preparers to the standards applicable to taxpayers will simplify the law by reducing confusion inherent in different standards applying to the same behavior.

Explanation of Provision

The provision alters the standards of conduct that must be met to avoid imposition of the first penalty. The provision 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 provision 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 provision 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 provision is effective for documents prepared after the date of enactment.

K. Penalty for Failure to Report Interests in Foreign Financial Accounts (sec. 312 of the bill and sec. 5321 of Title 31, United States Code)

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.[94] 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.[95] 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.[96]

On April 26, 2002, the Secretary of the Treasury submitted to the Congress a report on these reporting requirements.[97] This report, which was statutorily required,[98] 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.

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[94] 31 U.S.C. 5314.

[95] 31 U.S.C. 5321(a)(5).

[96] 31 U.S.C. 5322.

[97] *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.

[98] Sec. 361(b) of the USA PATRIOT Act of 2001 (Pub. L. 107-56).

Reasons for Change

The Committee understands that the number of individuals involved in using offshore bank accounts to engage in abusive tax scams has grown significantly in recent years. For one scheme alone, the IRS estimates that there may be one to two million taxpayers with offshore bank accounts attempting to conceal income from the IRS. The Committee is concerned about this activity and believes that improving compliance with this reporting requirement is vitally important to sound tax administration, to combating terrorism, and to preventing the use of abusive tax schemes and scams. Adding a new civil penalty that applies without regard to willfulness will improve compliance with this reporting requirement.

Explanation of Provision

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

Effective Date

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

L. Frivolous Tax Returns and Submissions (sec. 313 of the bill and sec. 6702 of the Code)

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[99] 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)).

Reasons for Change

The IRS has been faced with a significant number of tax filers who are filing returns based on frivolous arguments or who are seeking to hinder tax administration by filing returns that are patently incorrect. In addition, taxpayers are using existing procedures for collection due process hearings, offers-in-compromise, installment agreements, and taxpayer assistance orders to impede or delay tax administration by raising frivolous arguments. These procedures were intended to provide assistance to taxpayers genuinely seeking to resolve legitimate disputes with the IRS, and the use of these procedures for impeding or delaying tax administration diverts

[99] 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.

scarce IRS resources away from resolving genuine disputes. Allowing the IRS to assert more substantial penalties for frivolous submissions and to dismiss frivolous requests without the need to follow otherwise mandated procedures will deter frivolous taxpayer behavior and enable the IRS to use its resources to better assist taxpayers in resolving genuine disputes.

Explanation of Provision

The provision 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 provision 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 provision applies are requests for a collection due process hearing, installment agreements, offers-in-compromise, and taxpayer assistance orders. First, the provision permits the IRS to dismiss such requests. Second, the provision 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 provision requires the IRS to publish a list of positions, arguments, requests, and submissions determined to be frivolous for purposes of these provisions.

Effective Date

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

M. Penalties on Promoters of Tax Shelters
(sec. 314 of the bill and sec. 6700 of the Code)

Present Law

A penalty is imposed on any person who organizes, assists in the organization of, or participates in the sale of any interest in, a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if in connection with such activity the person makes or furnishes a qualifying false or fraudulent statement or a gross valuation overstatement.[100] 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

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[100] Sec. 6700.

penalty attributable to a gross valuation misstatement can be waived on a showing that there was a reasonable basis for the valuation and it was made in good faith.

Reasons for Change

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

Explanation of Provision

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

Effective Date

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

N. Extend Statute of Limitations for Certain Undisclosed Transactions (sec. 315 of the bill and sec. 6501 of the Code)

Present Law

In general, the Code requires that taxes be assessed within three years[101] after the date a return is filed.[102] 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.[103] 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.[104]

Reasons for Change

The Committee believes that extending the statute of limitations if a taxpayer required to disclose a listed transaction fails to do so will encourage taxpayers to provide the required

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[101] Sec. 6501(a).

[102] 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)).

[103] Sec. 6501(e).

[104] Sec. 6501(c).

disclosure and will afford the IRS additional time to discover the transaction if the taxpayer does not disclose it.

<u>Explanation of Provision</u>

The provision extends the statute of limitations to six years with respect to the entire tax return[105] if a taxpayer required to disclose a listed transaction[106] 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.[107]

<u>Effective Date</u>

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

O. Deny Deduction for Interest Paid to IRS on Underpayments Involving Certain Tax-Motivated Transactions (sec. 316 of the bill and sec. 163 of the Code)

<u>Present Law</u>

In general, corporations may deduct interest paid or accrued within a taxable year on indebtedness.[108] Interest on indebtedness to the Federal government attributable to an underpayment of tax generally may be deducted pursuant to this provision.

<u>Reasons for Change</u>

The Committee believes that it is inappropriate for corporations to deduct interest paid to the Government with respect to certain tax shelter transactions.

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[105] The tax year extended is the tax year the transaction is entered into.

[106] The term "listed transaction" has the same meaning as described in a previous provision regarding the penalty for failure to disclose reportable transactions.

[107] 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 provision does not re-open the statute of limitations for such year.

[108] Sec. 163(a).

Explanation of Provision

The provision disallows any deduction for interest paid or accrued within a taxable year on any portion of an underpayment of tax that is attributable to an understatement arising from (1) an undisclosed reportable avoidance transaction, (2) an undisclosed listed transaction, or (3) a transaction that lacks economic substance.[109]

Effective Date

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

[109] The definitions of these transactions are the same as those previously described in connection with the provision to modify the accuracy-related penalty for listed and certain reportable transactions and the provision to impose a penalty on understatements attributable to transactions that lack economic substance.

SUBTITLE B – ENRON-RELATED TAX SHELTER RELATED PROVISIONS

A. Limitation on Transfer and Importation of Built-In Losses (sec. 321 of the bill and secs. 362 and 334 of the Code)

Present Law

Generally, no gain or loss is recognized when one or more persons transfer property to a corporation in exchange for stock and immediately after the exchange such person or persons control the corporation.[110] 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.[111]

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.[112]

Reasons for Change

The Joint Committee on Taxation's Investigative Report of Enron and other information reveals that taxpayers are engaging in various tax motivated transactions to duplicate a single economic loss and, subsequently, deduct such loss more than once. Congress has previously taken actions to limit the ability of taxpayer's to engage in specific transactions that purport to duplicate a single economic loss. However, new schemes that purport to duplicate losses continue to proliferate. In furtherance of the overall tax policy objective of accurately measuring taxable income, the Committee believes that a single economic loss never should be deducted more than once. To accomplish this, the Committee believes that it is appropriate to generally limit a corporation's basis in property acquired in a tax-free transfer to the fair market value of such property. In addition, the Committee believes that it is appropriate to prevent the importation economic losses into the U.S. tax system if such losses arose prior to the assets becoming subject to the U.S. tax system.

Explanation of Provision

Importation of built-in losses

The provision 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

[110] Sec. 351.

[111] Sec. 358.

[112] Secs. 334(b) and 362(a) and (b).

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 provision, 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

The provision 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 provision, any required basis reduction is allocated among the transferred properties in proportion to their built-in-loss immediately before the transaction. In the case of a transfer in 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 provision is made to the stock received by the transferor and not to the assets transferred.

Effective Date

The provision applies to transactions after February 13, 2003.

B. No Reduction of Basis Under Section 734 in Stock Held By Partnership in Corporate Partner (sec. 322 of the bill and sec. 755 of the Code)

Present Law

In general

Generally, a partner and the partnership do not recognize gain or loss on a contribution of property to a partnership.[113] Similarly, a partner and the partnership generally do not recognize gain or loss on the distribution of partnership property.[114] This includes current distributions and distributions in liquidation of a partner's interest.

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[113] Sec. 721(a).

[114] Sec. 731(a) and (b).

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).[115] 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.[116] 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 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.[117] 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.[118]

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[115] Sec. 732(b).

[116] Sec. 754.

[117] Sec. 755(a).

[118] Sec. 755(b).

Reasons for Change

The Joint Committee on Taxation's Investigative Report of Enron revealed that certain transactions were being undertaken that purport to use the interaction of the partnership basis adjustment rules and the rules protecting a corporation from recognizing gain on its stock to obtain unintended tax results. These transactions generally purport to increase the tax basis of depreciable assets and to decrease, by a corresponding amount, the tax basis of the stock of a partner. Because the tax rules protect a corporation from gain on the sale of its stock (including through a partnership), the transactions enable taxpayers to duplicate tax deductions at no economic cost. The provision precludes the ability to reduce the basis of corporate stock of a partner (or related party) in certain transactions.

Explanation of Provision

The provision provides that in applying the basis allocation rules to a distribution in liquidation of a partner's interest, a partnership is precluded from decreasing the basis of corporate stock of a partner or a related person. Any decrease in basis that, absent the 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.

C. Repeal of Special Rules for FASITs (sec. 323 of the bill and secs. 860H through 860L of the Code)

Present Law

Financial asset securitization investment trusts

In 1996, Congress created a new type of statutory entity called a "financial asset securitization trust" ("FASIT") that facilitates the securitization of debt obligations such as credit card receivables, home equity loans, and auto loans.[119] 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

[119] Sections 860H through 860L.

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;[120] (2) have assets substantially all of which (including assets that the FASIT is treated as owning because they support regular interests) are specified types called "permitted assets;" (3) have non-ownership interests be certain specified types of debt instruments called "regular interests"; (4) have a single ownership interest which is held by an "eligible holder"; and (5) not qualify as a regulated investment company ("RIC"). Any entity, including a corporation, partnership, or trust may be treated as a FASIT. In addition, a segregated pool of assets may qualify as a FASIT.

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

Permitted assets

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

"Regular interests" of a FASIT

"Regular interests" of a FASIT are treated as debt for Federal income tax purposes, regardless of whether instruments with similar terms issued by non-FASITs might be characterized as equity under general tax principles. To be treated as a "regular interest", an instrument 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.

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[120] 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.

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.

Reasons for Change

The Joint Committee on Taxation's Investigative Report of Enron and other information described two structured tax-motivated transactions--Projects Apache and Renegade--that Enron undertook in which the use of a FASIT was a key component in the structure of the transactions. The Committee is aware that FASITs are not being used widely in the manner envisioned by the Congress and, consequently, the FASIT rules have not served the purpose for which they originally were intended. Moreover, the Joint Committee's report indicates that FASITs are particularly prone to abuse and likely are being used primarily to facilitate tax avoidance transactions. Therefore, the Committee believes that the potential for abuse that is inherent in FASITs far outweighs any beneficial purpose that the FASIT rules may serve. Accordingly, the Committee believes that these rules should be repealed, with appropriate transition relief for existing FASITs.

Explanation of Provision

The provision repeals the special rules for FASITs. The provision provides a transition period for existing FASITs, pursuant to which the repeal of the FASIT rules 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 provision is effective after February 13, 2003.

D. Expanded Disallowance of Deduction for Interest on Convertible Debt (sec. 324 of the bill and sec. 163 of the Code)

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.[121] 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.[122] 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.[123]

Reasons for Change

The Joint Committee on Taxation's Investigative Report of Enron and other information described two structured financing transactions that Enron undertook in 1995 and 1999 involving what the report referred to as "investment unit securities." In substance, these securities featured

[121] Sec. 163(l), enacted in the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1005(a).

[122] Sec. 163(l)(3)(B).

[123] Sec. 163(l)(3)(C).

principal repayment that was not unconditional in amount, as generally is required in order for debt characterization to be respected for tax purposes. Instead, principal on the securities was payable upon maturity in stock of an Enron affiliate (or in cash equivalent to the value of such stock).

The Committee believes that the financing activities undertaken by Enron in 1995 and 1999 using investment unit securities cast doubt upon the tax policy rationale for excluding stock ownership interests of 50 percent or less (by virtue of the present-law related party definition) from the application of the interest expense disallowance rules for certain convertible equity-linked debt instruments. With regard to the securities issued by Enron, the fact that Enron owned more than 50 percent of the affiliate stock at the time of the 1995 issuance but owned less than 50 percent of such stock at the time of the 1999 issuance (or shortly thereafter) had no discernible bearing on the intent or economic consequences of either transaction. In each instance, the transaction did not involve a borrowing by Enron in substance for which an interest deduction is appropriate. Rather, these transactions had the purpose and effect of carrying out a monetization of the affiliate stock. Nevertheless, the tax consequences of the 1995 issuance likely would have been different from those of the 1999 issuance if the present-law rules had been in effect at the time of both transactions, rather than only at the time of the 1999 transaction (to which the interest expense disallowance rules did not apply because of the present-law 50-percent related party threshold). Therefore, the Committee believes that eliminating the related party threshold for the application of these rules furthers the tax policy objective of similar tax treatment of economically equivalent transactions.

Explanation of Provision

The provision expands the present-law disallowance of interest deductions on certain convertible or equity-linked corporate debt that is payable in, or by reference to the value of, equity. Under the provision, the disallowance is expanded to include interest on corporate debt that is payable in, or by reference to the value of, any equity held by the issuer (or by any related party) in any other person, without regard to whether such equity represents more than a 50-percent ownership interest in such person. However, the provision does not apply to debt that is issued by an active dealer in securities (or by 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 provision applies to debt instruments that are issued after February 13, 2003.

E. Expanded Authority to Disallow Tax Benefits Under Section 269 (sec. 325 of the bill and sec. 269 of the Code)

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.[124] 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.[125]

Reasons for Change

The Joint Committee on Taxation's Investigative Report of Enron highlights the limited reach of section 269. Present-law section 269 is circumscribed because it only applies to tax benefits that can be obtained only through the acquisition of control. Tax avoidance transactions involving the acquisition of a non-controlling interest in a corporation are no less pernicious (and actually may be more prevalent) than similarly motivated transactions involving the acquisition of a controlling interest in a corporation. Therefore, the Committee believes it is appropriate to expand its application to acquisitions, without regard to whether such interests provide to the acquirer control of the corporation, if the principal purpose of the acquisition is the evasion or avoidance of Federal income tax.

Explanation of Provision

The provision 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 provision, section 269 disallows the tax benefits of (1) any acquisition of stock in a corporation,[126] 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 provision applies to stock and property acquired after February 13, 2003.

[124] Sec. 269(a)(1).

[125] Sec. 269(a)(2).

[126] In this regard, the provision 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.

F. Modifications of certain rules relating to controlled foreign corporations (sec. 326 of the bill and sec. 1297(e) of the Code)

Present Law

The United States employs a "worldwide" tax system, under which domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Income earned by a domestic parent corporation from foreign operations conducted by 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[127] and the passive foreign investment company rules.[128] 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.[129]

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,[130] 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).[131] Under the subpart F rules, the United States generally taxes the U.S. 10-percent shareholders of a controlled foreign corporation on their pro

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[127] Secs. 951-964.

[128] Secs. 1291-1298.

[129] Secs. 901, 902, 960, 1291(g).

[130] Secs. 951-964.

[131] 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.[132]

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,[133] insurance income,[134] and certain income relating to international boycotts and other violations of public policy.[135] 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.[136]

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.[137]

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.[138] 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.[139] 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

[132] Sec. 951(a).

[133] Sec. 954.

[134] Sec. 953.

[135] Sec. 952(a)(3)-(5).

[136] Sec. 954.

[137] Secs. 951(a)(1)(B), 956.

[138] Sec. 1297.

[139] Sec. 1293-1295.

deferral.[140] 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."[141]

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).

Reasons for Change

The Committee is aware that section 1297(e) may enable a U.S. shareholder (like Enron in the "Project Apache" transaction)[142] to claim exemption from the passive foreign investment company rules with respect to ownership of controlled foreign corporation stock on the basis of mere status as a U.S. shareholder, despite the fact that the U.S. shareholder may have implemented a structure intended to render it impossible for such shareholder to recognize any income under subpart F in connection with the stock. The Committee believes that the passive foreign investment company rules should be available to serve as a backstop to subpart F in such circumstances, and thus believes that the exception to the passive foreign investment company rules for U.S. shareholders of controlled foreign corporations should be geared more closely to the U.S. shareholder's potential taxability under subpart F, as opposed to mere status as a U.S. shareholder under subpart F.

Description of Provision

The provision 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.

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[140] Sec. 1291.

[141] Sec. 1296.

[142] *See* Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JCS-3-03), February 2003, vol. I at 255, 258-59.

Effective Date

The provision 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.

G. Modify Treatment of Closely-Held REITs (sec. 327 of the bill and sec. 856 of the Code)

Present Law

In general, a real estate investment trust ("REIT") is an entity that receives most of its income from passive real estate related investments and that receives pass-through treatment for income that is distributed to shareholders. If an entity meets the qualifications for REIT status and elects to be taxed as a REIT, the portion of its income that is distributed to the investors each year generally is taxed to the investors without being subjected to tax at the REIT level.

A REIT must satisfy a number of tests on a year-by-year basis that relate to the entity's (1) organizational structure; (2) source of income; (3) nature of assets; and (4) distribution of income.

Under the organizational structure test, except for the first taxable year for which an entity elects to be a REIT, the beneficial ownership of the entity must be held by 100 or more persons. Generally, no more than 50 percent of the value of the REIT stock can be owned by five or fewer individuals during the last half of the taxable year. Certain attribution rules apply in making this determination.

Reasons for Change

REITs allow individual investors to obtain a single level of tax on passive real estate investments, often in publicly-traded entities. The present law requirements that REIT ownership interests must be held by at least 100 persons and that 5 or fewer individuals cannot own more than 50 percent of the value of the REIT indicate that Congress intended that REIT benefits not be available to closely held entities.

The Committee is concerned that a single corporate shareholder or a small group of shareholders may be able to utilize a REIT to achieve tax benefits based on their individual tax situations. One example of such use might be to place various assets in a REIT in order to obtain "dividend" treatment for income from the REIT when desired, even though the assets if held directly might produce a different form of income (e.g., interest income).

Explanation of Provision

The bill imposes as an additional requirement for REIT qualification that, except for the first taxable year for which an entity elects to be a REIT, no person can own stock of a REIT possessing 50 percent or more of the combined voting power of all classes of voting stock or 50 percent or more of the total value of all classes of stock of the REIT. For purposes of determining a person's stock ownership, rules similar to attribution rules for REIT qualification under present law apply (secs. 856(d)(5) and 856(h)(3)). A special rule prevents reattribution in certain circumstances.

The provision does not apply to ownership by a REIT of 50 percent or more of the stock (vote or value) of another REIT.

An exception applies for a limited period of time to certain "incubator REITs" that meet specified qualifications. A penalty is imposed on a corporation's directors if an "incubator REIT" election is made for a principal purpose other than as part of a reasonable plan to undertake a going public transaction (as defined in the bill).

Effective Date

The bill is effective for entities electing REIT status for taxable years ending after May 8, 2003. Any entity that elects (or has elected) REIT status for a taxable year including May 8, 2003 , and which is both a controlled entity and has significant business assets or activities on such date, will not be subject to the bill. Under this rule, a controlled entity with significant business assets or activities on May 8, 2003, can be grandfathered even if it makes its first REIT election after that date with its return for the taxable year including that date.

For purposes of the transition rules, the significant business assets or activities in place on May 8, 2003 must be real estate assets and activities of a type that would be qualified real estate assets and would produce qualified real estate related income for a REIT.

SUBTITLE C – OTHER CORPORATE GOVERNANCE PROVISIONS

A. Affirmation of Consolidated Return Regulation Authority (sec. 331 of the bill and sec. 1502 of the Code)

Present Law

An affiliated group of corporations may elect to file a consolidated return in lieu of separate returns. A condition of electing to file a consolidated return is that all corporations that are members of the consolidated group must consent to all the consolidated return regulations prescribed under section 1502 prior to the last day prescribed by law for filing such return.[143]

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.[144]

Under this authority, the Treasury Department has issued extensive consolidated return regulations.[145]

In the recent case of *Rite Aid Corp. v. United States*,[146] the Federal Circuit Court of Appeals addressed the application of a particular provision of certain consolidated return loss

[143] Sec. 1501.

[144] Sec. 1502.

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

disallowance regulations, and concluded that the provision was invalid.[147] The particular provision, known as the "duplicated loss" provision,[148] 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.[149]

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[146] 255 F.3d 1357 (Fed. Cir. 2001), *reh'g denied*, 2001 U.S. App. LEXIS 23207 (Fed. Cir. Oct. 3, 2001).

[147] 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."

[148] Treas. Reg. Sec. 1.1502-20(c)(1)(iii).

[149] 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

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.[150]

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."[151] 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." [152]

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adjusted upward on recognition of any built-in income or gain of the subsidiary reflected in that value. The regulations also contained the duplicated loss factor addressed by the court in *Rite Aid*. The preamble to the regulations stated: "it is not administratively feasible to differentiate between loss attributable to built-in gain and duplicated loss." T.D. 8364, 1991-2 C.B. 43, 46 (Sept. 13, 1991). The government also argued in the *Rite Aid* case that duplicated loss was a separate concern of the regulations. 255 F.3d at 1360.

[150] 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).

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

[152] *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

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.[153]

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.[154]

Reasons for Change

The Committee is concerned that the language and analysis in the *Rite Aid* decision might lead taxpayers to attempt to challenge other Treasury consolidated return regulations that prescribe a tax result different from the result that would occur if separate returns were filed.

The Committee is concerned that any such challenges may lead to protracted litigation and commitment of Internal Revenue Service resources to defending the consolidated return provisions.

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that the allocation method adopted by the regulation allowed non-WHTC losses to reduce WHTC income. However, the court did not disallow a method that would net WHTC income of one WHTC with losses of another WHTC, a result that would not have occurred under separate returns. Nor did the court expressly disallow a different fractional method that would net both income and losses of the WHTCs with those of other corporations in the consolidated group. The court also found that the regulation had been adopted without proper notice.

[153] *Rite Aid*, 255 F.3d at 1360.

[154] *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).

The Committee wishes to clarify that the fact that a result under the consolidated return regulations differs from the result under separate returns does not provide a basis to challenge a Treasury consolidated return regulation.

The Committee believes that the result of the case with respect to the type of factual situation in *Rite Aid*, involving the "duplicated loss factor" portion of Treasury Regulation section 1.1502-20, which Treasury has announced that taxpayers need not follow, should not be overturned. Therefore, the committee legislatively allows the specific result of the case to stand for the taxpayer in *Rite Aid* or any similarly situated taxpayers.

Apart from that specific result, the Committee disagrees with the reasoning of the case and believes it should not be applied to support any challenge to other consolidated return regulations. The Committee also wishes to reaffirm the broad authority of the Treasury Department to issue consolidated return regulations.

Explanation of Provision

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

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

Rite Aid is thus overruled to the extent it suggests that 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 provision nevertheless allows the result of the *Rite Aid* case to stand with respect to the type of factual situation presented in the case. That is, the 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[155] to the extent the subsidiary had net operating losses or built in losses that could be used later outside the group.[156]

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[155] Treas. Reg. Sec. 1.1502-20(c)(1)(iii).

[156] The provision 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).

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.[157]

Effective Date

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

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

B. Chief Executive Officer Required To Sign Corporate Income Tax Returns (sec. 332 of the bill and sec. 6062 of the Code)

Present Law

The Code requires[158] 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[159] 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[160] ($500,000 in the case of a corporation) or imprisonment of not more than three years, or both, together with the costs of prosecution.

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[157] *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.

[158] Sec. 6062.

[159] Sec. 7206.

[160] Pursuant to 18 U.S.C. 3571, the maximum fine for an individual convicted of a felony is $250,000.

Reasons for Change

The Committee believes that the filing of accurate tax returns is essential to the proper functioning of the tax system. The Committee believes that requiring that the chief executive officer of a corporation sign its corporate income tax returns will elevate the level of care given to the preparation of those returns.

Explanation of Provision

The bill requires that the chief executive officer of a corporation sign that corporation's income tax returns.[161] 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. The Committee intends 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. The Committee intends that, in every instance, the highest ranking corporate officer (regardless of title) sign the tax return.

The provision does not apply to the income tax returns of mutual funds;[162] they are required to be signed as under present law.

Effective Date

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

C. Denial of Deduction for Certain Fines, Penalties, and Other Amounts (sec. 335 of the bill and sec. 162 of the Code)

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."[163]

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[161] Because the provision amends section 6062, it applies only to the Form 1120 itself (or its equivalent) and any disclosures required under section 6662 or related provisions. It does not apply to any other schedules or attachments.

[162] The provision does, however, apply to the income tax returns of mutual fund management companies and advisors.

[163] S. Rep. 91-552, 91st Cong, 1st Sess., 273-74 (1969), referring to *Tank Truck Rentals, Inc. v. Commissioner*, 356 U.S. 30 (1958).

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.

Reasons for Change

The Committee is concerned that there is a lack of clarity and consistency under present law regarding when taxpayers may deduct payments made in settlement of government investigations of potential wrongdoing, as well as in situations where there has been a final determination of wrongdoing. If a taxpayer deducts payments made in settlement of an investigation of potential wrongdoing or as result of a finding of wrongdoing, the announced amount of the payment does not true cost to the taxpayer. The Committee is also concerned that allowing a deduction for such payments in effect shifts a portion of the cost to the Federal government.

Explanation of Provision

The bill modifies the rules regarding the determination whether payments are nondeductible payments of fines or penalties under section 162(f). In particular, the bill 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 [164] are nondeductible under any provision of the income tax provisions.[165] The bill 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.[166]

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[164] The bill does not affect amounts paid or incurred in performing routine audits or reviews such as annual audits that are required of all organizations or individuals in a similar business sector, or profession, as a requirement for being allowed to conduct business. However, if the government or regulator raised an issue of compliance and a payment is required in settlement of such issue, the bill would affect that payment.

[165] The bill provides that such amounts are nondeductible under chapter 1 of the Internal Revenue Code.

[166] The bill 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).

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 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.[167] 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 (whether by suit, agreement, or otherwise) 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 likewise subject to the provision if paid in relation to a violation, or investigation or inquiry into a potential violation, of any law (or any rule or other requirement of such entity). 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 similarly subject to the provision. The exception for payments that the taxpayer establishes are restitution likewise applies in these cases.

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 bill 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.

[167] 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.

D. Denial of Deduction for Punitive Damages
(sec. 334 of the bill and sec. 162 of the Code)

Present Law

In general, a deduction is allowed for all ordinary and necessary expenses that are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business.[168] However, no deduction is allowed for any payment that is made to an official of any governmental agency if the payment constitutes an illegal bribe or kickback or if the payment is to an official or employee of a foreign government and is illegal under Federal law.[169] In addition, no deduction is allowed under present law for any fine or similar payment made to a government for violation of any law.[170] Furthermore, no deduction is permitted for two-thirds of any damage payments made by a taxpayer who is convicted of a violation of the Clayton antitrust law or any related antitrust law.[171]

In general, gross income does not include amounts received on account of personal physical injuries and physical sickness.[172] However, this exclusion does not apply to punitive damages.[173]

Reasons for Change

The Committee believes that allowing a tax deduction for punitive damages undermines the societal role of punitive damages in discouraging and penalizing the activities or actions for which punitive damages are imposed. Furthermore, the Committee believes that determining the amount of punitive damages to be disallowed as a tax deduction is not administratively burdensome because taxpayers generally can make such a determination readily by reference to pleadings filed with a court, and plaintiffs already make such a determination in determining the taxable portion of any payment.

Explanation of Provision

The provision denies any deduction for punitive damages that are paid or incurred by the taxpayer as a result of a judgment or in settlement of a claim. If the liability for punitive damages is covered by insurance, any such punitive damages paid by the insurer are included in

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[168] Sec. 162(a).

[169] Sec. 162(c).

[170] Sec. 162(f).

[171] Sec. 162(g).

[172] Sec. 104(a).

[173] Sec. 104(a)(2).

gross income of the insured person and the insurer is required to report such amounts to both the insured person and the IRS.

Effective Date

The provision is effective for punitive damages that are paid or incurred on or after the date of enactment.

E. Executive Compensation Reforms (sec. 335, 336 and 337 of the bill and sec. 83 and new sec. 409A of the Code)

Present Law

Property transferred in connection with the performance of services

Section 83 applies to transfers of property in connection with the performance of services. Under section 83, if, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of the fair market value of such property over the amount (if any) paid for the property is includible in income at the first time that the property is transferable or not subject to substantial risk of forfeiture.

Stock granted to an employee (or other service provider) is subject to the rules that apply under section 83. When stock is vested and transferred to an employee, the excess of the fair market value of the stock over the amount, if any, the employee pays for the stock is includible in the employee's income for the year in which the transfer occurs.

The income taxation of a nonqualified stock option is determined under section 83 and depends on whether the option has a readily ascertainable fair market value. If the nonqualified option does not have a readily ascertainable fair market value at the time of grant, no amount is includible in the gross income of the recipient with respect to the option until the recipient exercises the option. The transfer of stock on exercise of the option is subject to the general rules of section 83. That is, if vested stock is received on exercise of the option, the excess of the fair market value of the stock over the option price is includible in the recipient's gross income as ordinary income in the taxable year in which the option is exercised. If the stock received on exercise of the option is not vested, the excess of the fair market value of the stock at the time of vesting over the option price is includible in the recipient's income for the year in which vesting occurs unless the recipient elects to apply section 83 at the time of exercise.

Other forms of stock-based compensation are also subject to the rules of section 83.

Nonqualified deferred compensation

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,[174] 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.[175] 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 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

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[174] *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.

[175] Treas. Reg. sec. 1.83-3(e). This definition in part reflects previous IRS rulings on nonqualified deferred compensation.

requirement to relinquish a valuable right in order to make withdrawals is generally treated as a substantial limitation or restriction.

Rabbi trusts

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

As discussed above, for purposes of section 83, property includes a beneficial interest in assets set aside from the claims of creditors, such as in a trust or fund, but does not include an unfunded and unsecured promise to pay money in the future. In the case of a rabbi trust, terms providing that the assets are subject to the claims of creditors of the employer in the case of insolvency or bankruptcy have been the basis for the conclusion that the creation of a rabbi trust does not cause the related nonqualified deferred compensation arrangement to be funded for income tax purposes.[176] 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.[177] Revenue Procedure 92-64 provides a safe harbor for taxpayers who adopt and maintain grantor trusts in 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 individuals, while still meeting the safe harbor requirements set forth by the IRS.

Reasons for Change

The report issued by the staff of the Joint Committee on Taxation on their investigation of Enron Corporation, [178] which was mandated by the Committee, detailed how executives

[176] 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).

[177] Rev. Proc. 92-64, 1992-2 C.B. 422, modified in part by Notice 2000-56, 2000-2 C.B. 393.

[178] Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JCS-3-03), February 2003

deferred millions of dollars in Federal income taxes through nonqualified deferred compensation arrangements. Over $150 million in compensation was deferred by the 200-highest compensated employees for the years 1998 through 2001.

The Committee is also aware of the popular use of deferred compensation arrangements by executives of many other companies to defer current taxation of substantial amounts of income. As in the case of Enron, executives often use arrangements which allow deferral of income, but also provide security of future payment to the executive. The Committee believes that many nonqualified deferred compensation arrangements have developed that allow improper deferral of income. The Committee believes that certain arrangements should be treated as funded and not result in deferral of income. The Committee also believes that certain arrangements that allow participants access to the amounts deferred should not result in deferral of income inclusion.

Since the concept of a rabbi trust was developed, techniques have developed that attempt to protect the assets from creditors despite the terms of the trust. For example, the trust or fund may be located in a foreign jurisdiction, making it difficult or impossible for creditors to reach the assets. Amounts used to provide deferred compensation that are held in a trust located in a foreign jurisdiction are difficult to reach by creditors; in many cases so difficult that the assets are effectively out of the reach of general creditors. The Committee believes that except in limited situations, the primary purpose of such arrangements is to protect the assets from the claims of general creditors. Thus, such assets should not be considered to be subject to the claims of creditors under U.S. tax laws.

The Committee is also aware of the use of certain programs that allow executives to defer taxes attributable to stock option gains and restricted stock gains by exchanging their interest in the property for a future payment of such gain. The report of the staff of the Joint Committee on Taxation showed that executives at Enron Corporation deferred Federal income taxes under such programs. The Committee does not believe that such practices should be allowed to continue as they result in inappropriate timing of income.

Explanation of Provisions

Taxation of nonqualified deferred compensation funded with assets located outside of the United States

The provision provides that assets that are designated or otherwise available for the use of providing nonqualified deferred compensation and are located outside the United States (e.g., in a foreign trust, arrangement or account) are not treated as subject to the claims of general creditors. Therefore, to the extent of such assets, nonqualified deferred compensation amounts are not treated as unfunded and unsecured promises to pay, but are treated as property under section 83 and includible in income when the right to the compensation is no longer subject to a substantial risk of forfeiture, regardless of when the compensation is paid. No inference is intended that nonqualified deferred compensation assets located outside of the U.S. would be treated as subject to the claims of creditors under present law.

The provision does not apply to assets located in a foreign jurisdiction if substantially all of the services to which the nonqualified deferred compensation relates are performed in such foreign jurisdiction.

The provision is specifically intended to apply to foreign trusts and arrangements that effectively shield from the claims of general creditors any assets intended to satisfy nonqualified deferred compensation obligations. The provision provides the Secretary of the Treasury authority to prescribe regulations as are necessary to carry out the provision and to provide additional exceptions for specific arrangements which do not result in improper deferral of U.S. tax if the assets involved in the arrangement are readily accessible in any insolvency or bankruptcy proceeding.

Inclusion in gross income of funded deferred compensation of corporate insiders

Under the provision, if an employer maintains a funded deferred compensation plan,[179] compensation of any disqualified individual which is deferred under the plan is includible in the gross income of the individual or beneficiary for the first taxable year in which there is no substantial risk of forfeiture.[180]

Under the provision, a plan is treated as a funded deferred compensation plan unless (1) the employee's rights to the compensation deferred under the plan, and all income attributable to such amounts, are no greater than the rights of a general creditor of the employer; (2) until made available to the participant or beneficiary, all amounts set aside (directly or indirectly) for the purposes of paying the deferred compensation, and all income attributable to such amounts, remain solely the property of the employer and are not restricted to the provision of benefits under the plan; (3) at all times (not merely after bankruptcy or insolvency), all amounts set aside are available to satisfy the claims of the employer's general creditors; and (4) investment options under which a participant may elect under the nonqualified deferred compensation plan are the same as those which may be elected by participants of the qualified employer plan that has the fewest investment options. Under the provision, if amounts are set aside for the exclusive purpose of paying deferred compensation benefits, the plan is treated as a funded plan. Amounts set aside in an employer's general assets, even if such assets are segregated for bookkeeping or accounting purposes, which are not restricted to the payment of deferred compensation, and are subject to the claims of general creditors, are not treated as funded if the other requirements under the provision are satisfied.

[179] A plan includes an agreement or arrangement.

[180] Compensation is treated as subject to a substantial risk of forfeiture if the rights to such compensation are conditioned upon the future performance of substantial services by any individual. If an arrangement is treated as a funded deferred compensation plan under the provision, amounts may be includible in gross income before they are paid or made available. In determining the tax treatment of amounts available under the plan, the rules applicable to the taxation of annuities apply.

An employee's right to deferred compensation is treated as greater than the rights of general creditors unless (1) the deferred compensation, and all income attributable to such amounts, is payable only upon separation from service, disability, death, or at a specified time (or pursuant to a fixed schedule) and (2) the plan does not permit the acceleration of the time of such payments by reason of any event. Amounts payable upon a specified 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 by reason 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. A plan which allows payment of deferred compensation or earnings other than upon separation from service, disability, death, or specified time, or allows for any acceleration of payments, is treated as funded and compensation deferred under such plan is includible in income when the rights to such compensation are not subject to a substantial risk of forfeiture.

Even if an employee's rights are treated as no greater than the rights of general creditors in compliance with the previously discussed criteria, if the employer and employee agree to a modification of the plan that accelerates the time for payment of deferred compensation, then all compensation previously deferred is includible in gross income for the taxable year in which the modification takes effect. In addition, upon such a modification, the taxpayer is required to pay interest at the underpayment rate on the underpayments that would have occurred had the deferred compensation been includible in gross income on the earliest date that there is no substantial risk of forfeiture of the right to the compensation. Such interest is treated as interest on an underpayment of tax.

With respect to amounts set aside in a trust, a plan is treated as failing to meet the requirement that amounts set aside remain solely the property of the employer and are not restricted to the payment of benefits under the plan unless certain specified criteria are met: (1) the employee must have no beneficial interest in the trust; (2) assets in the trust must be available to satisfy the claims of general creditors at all times (not merely after bankruptcy or insolvency); and (3) no factor can exist which would make it more difficult for general creditors to reach the assets in the trust than it would be if the trust assets were held directly by the employer in the United States. The location of the trust outside of the United States is such a prohibited factor, unless substantially all of the services to which the nonqualified deferred compensation relates are performed in such foreign jurisdiction. The provision provides the Secretary of the Treasury authority to provide additional exceptions from the requirement for specific arrangements which do not result in improper deferral of U.S. tax if the assets involved in the arrangement are readily accessible to general creditors. If any of the criteria are not satisfied, the trust is treated as a funded arrangement and compensation deferred is includible in gross income when such compensation is not subject to a substantial risk of forfeiture.

A disqualified individual is any individual who, with respect to a corporation, is subject to the requirements of section 16(a) of the Securities Act of 1934, or would be subject to such requirements if such corporation were an issuer of equity securities referred to in that section.

Generally, disqualified individuals include officers (as defined by section 16(a)),[181] directors, or 10-percent owners of both private and publicly-held corporations.

A funded deferred compensation plan does not include a qualified retirement plan or annuity, a tax-sheltered annuity, a simplified employee pension, a simple retirement account, certain plans funded solely by employee contributions, a governmental plan, or a plan of a tax-exempt organization. Present law rules continue to apply to plans or arrangements not subject to the provision (e.g., secs. 401(a), 403(b), and 457).

It is not intended that the provision change the tax treatment of trusts under section 402(b) or of any arrangements under which amounts are otherwise includible in income. It is not intended that the provision change the rules applicable to an employer's deduction for nonqualified deferred compensation.

The provision provides the Secretary of the Treasury authority to prescribe regulations as are necessary to carry out the provision.

Denial of deferral of certain stock option and restricted stock gains

Under the provision, gains attributable to stock options (including exercises of stock options), vesting of restricted stock, and other employer security based compensation cannot be deferred by electing to receive a future payment in lieu of such amounts. The provision applies even if the future right to payment is treated as an unfunded to promise to pay.

The provision is not intended to imply that such practices result in permissive deferral of income under present law.

Effective Dates

The provision relating to nonqualified deferred compensation assets located outside of the United States is effective for amounts deferred in taxable years beginning after December 31, 2003.

The provision requiring inclusion in income of funded nonqualified deferred compensation of corporate insiders is effective for amounts deferred in taxable years beginning after December 31, 2003.

The provision denying deferral of certain stock option and restricted stock gains is effective after December 31, 2003.

[181] 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.

F. Increase in Withholding from Supplemental Wage Payments in Excess of $1 million (sec. 338 of the bill and sec. 13273 of the Revenue Reconciliation Act of 1993)

Present Law

An employer must withhold income taxes from wages paid to employees; there are several possible methods for determining the amount of income tax to be withheld. The IRS publishes tables (Publication 15, "Circular E") to be used in determining the amount of income tax to be withheld. The tables generally reflect the income tax rates under the Code so that withholding approximates the ultimate tax liability with respect to the wage payments. In some cases, "supplemental" wage payments (e.g., bonuses or commissions) may be subject to withholding at a flat rate,[182] based on the third lowest income tax rate under the Code (27 percent for 2003).[183]

Reasons for Change

The Committee believes that because most employees who receive annual supplemental wage payments in excess of $1 million will ultimately be taxed at the highest marginal rate, it is appropriate to raise the withholding rate on such payments so that withholding more closely approximates the ultimate tax liability with respect to these payments.

Explanation of Provision

Under the provision, once annual supplemental wage payments to an employee exceed $1 million, any additional supplemental wage payments to the employee in that year are subject to withholding at the highest income tax rate (38.6 percent for 2003), regardless of any other withholding rules and regardless of the employee's Form W-4.

This rule applies only for purposes of wage withholding; other types of withholding (such as pension withholding and backup withholding) are not affected.

Effective Date

The provision is effective with respect to payments made after December 31, 2003.

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[182] Sec. 13273 of the Revenue Reconciliation Act of 1993.

[183] Sec. 101(c)(11) of the Economic Growth and Tax Relief Reconciliation Act of 2001.

SUBTITLE D – INTERNATIONAL PROVISIONS

A. Revision of Tax Rules on Expatriation (sec. 340 of the bill and secs. 102, 877, 2107, 2501, 7701 and 6039G of the Code)

Present Law

In general

U.S. citizens and residents generally are subject to U.S. income taxation on their worldwide income. The U.S. tax may be reduced or offset by a credit allowed for foreign income taxes paid with respect to foreign-source income. 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.[184] 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.[185] 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 applies only if it results in a higher U.S. tax

[184] 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.

[185] 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.

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.

<u>Estate tax rules with respect to expatriates</u>

Nonresident noncitizens generally are subject to estate tax on certain transfers of U.S.-situated property at death.[186] 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.

[186] 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).

<u>Gift tax rules with respect to expatriates</u>

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).

<u>Other tax rules with respect to expatriates</u>

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.

Reasons for Change

The Committee is aware that some individuals each year relinquish their U.S. citizenship or terminate their U.S. residency for the purpose of avoiding U.S. income, estate, and gift taxes. By so doing, such individuals reduce their annual U.S. income tax liability and reduce or eliminate their U.S. estate tax liability.

The Committee recognizes that citizens and residents of the United States have a right not only physically to leave the United States to live elsewhere, but also to relinquish their citizenship or terminate their residency. The Committee does not believe that the Internal Revenue Code should be used to stop U.S. citizens and residents from relinquishing citizenship or terminating residency; however, the Committee also does not believe that the Code should provide a tax incentive for doing so. In other words, to the extent possible, an individual's decision to relinquish citizenship or terminate residency should be tax-neutral.

The Committee is concerned that the present-law expatriation tax rules are difficult to administer. In addition, the Committee is concerned that the alternative method of taxation under section 877 can be avoided by postponing the realization of U.S.-source income for 10 years. The Committee believes that the expatriation tax rules are largely ineffective in taxing U.S. citizens and residents who relinquish citizenship or terminate residency with a principal purpose to avoid tax.

The Committee believes that the present-law expatriation tax rules should be replaced with a tax regime applicable to former citizens and residents that does not rely on establishing a tax avoidance motive. Because U.S. citizens and residents who retain their citizenship or residency generally are subject to income tax on accrued appreciation when they dispose of their assets, as well as estate tax on the full value of assets that are held until death, the Committee believes it fair to tax individuals on the appreciation in their assets when they relinquish their citizenship or terminate their residency. The Committee believes that an exception from such a tax should be provided for individuals with a relatively modest amount of appreciated assets. The Committee also believes that, where U.S. estate or gift taxes are avoided with respect to a transfer of property to a U.S. person by reason of the expatriation of the donor, it is appropriate for the recipient to be subject to an income tax based on the value of the property.

The Committee also believes that the present-law immigration rules applicable to former citizens are ineffective. The Committee believes that the rules should be modified to eliminate the requirement of proof of a tax avoidance purpose, and to coordinate the application of those rules with the tax rules provided under the new regime.

Explanation of Provision

In general

The provision 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 2003.

Individuals covered

Under the provision, 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.

<u>Election to be treated as a U.S. citizen</u>

Under the provision, 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 provision. 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 provision.

<u>Date of relinquishment of citizenship</u>

Under the provision, 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 provision 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 provision. Regulatory authority is granted to the Treasury to except other types of property from the provision.

Under the provision, 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 provision 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).[187] However, the provision contains a special rule for an interest in a "qualified retirement plan." For purposes of the provision, 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

[187] 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).

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 provision, 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 provision, 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 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 provision. 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 provision.

<u>Interests in trusts</u>

Under the provision, 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 provisions. 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.

<u>Nonqualified trusts</u>.–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.

<u>Qualified trusts</u>.–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 provision provides a coordination rule with the present-law alternative tax regime. Under the provision, 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 provision, 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 provision 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 provision.

Immigration rules

The provision 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 provision's expatriation tax provisions (regardless of the subjective motive for expatriating). For this purpose, the provision 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 provision 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 provision.

Effective Date

The provision 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.

B. Tax Treatment of Inverted Corporate Entities

1. Tax treatment of inverted corporate entities (sec. 342 of the bill and new sec. 7874 of the Code)

Present Law

Determination of corporate residence

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

U.S. taxation of domestic corporations

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

Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income is generally deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F[188] and the passive foreign investment company rules.[189] 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.

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[188] Secs. 951-964.

[189] Secs. 1291-1298.

U.S. taxation of foreign corporations

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

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

U.S. tax treatment of inversion transactions

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

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

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

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

Reasons for Change

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

Explanation of Provision

In general

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

Transactions involving at least 80 percent identity of stock ownership

The first type of inversion is a transaction in which, pursuant to a plan or a series of related transactions: (1) a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity;[190] (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.[191]

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

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

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[190] 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.

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

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

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

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

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

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

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

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

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

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

Partnership transactions

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

Effective Date

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

2. Excise tax on stock compensation of insiders in inverted corporations (sec. 343 of the bill and new sec. 5000A and sec. 275(a) of the Code)

Present Law

The income taxation of a nonstatutory[192] 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.[193] Upon exercise of such an option, the excess of the fair market value of the stock purchased over the option price is included in the recipient's gross income as ordinary income in such taxable year.

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

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

Reasons for Change

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

Explanation of Provision

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

[192] 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.

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

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

A disqualified individual is any individual who, with respect to a corporation, is, at any time during the 12-month period beginning on the date which is six months before the inversion date, subject to the requirements of section 16(a) of the Securities and Exchange Act of 1934 with respect to the corporation, or any member of the corporation's expanded affiliated group,[194] 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)),[195] directors, and 10-percent owners of private and publicly-held corporations.

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

Specified stock compensation subject to the excise tax includes any payment[196] (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,

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[194] 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.

[195] 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.

[196] Under the provision, any transfer of property is treated as a payment and any right to a transfer of property is treated as a right to a payment.

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

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

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

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

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

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

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

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

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

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

Effective Date

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

3. Reinsurance of United States risks in foreign jurisdictions (sec. 344 of the bill and sec. 845(a) of the Code)

Present Law

In the case of a reinsurance agreement between two or more related persons, present law provides the Treasury Secretary with authority to allocate among the parties or recharacterize income (whether investment income, premium or otherwise), deductions, assets, reserves, credits and any other items related to the reinsurance agreement, or make any other adjustment, in order to reflect the proper source and character of the items for each party.[197] 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.[198] In addition, the provision also permits such allocation, recharacterization, or other adjustments in a case in which one of the parties to a reinsurance agreement is, with respect to any contract covered by the agreement, in effect an agent of another party to the agreement, or a conduit between related persons.

Reasons for Change

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

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[197] Sec. 845(a).

[198] 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).

authority with respect to reinsurance agreements, the amount, source or character of the items may be allocated, recharacterized or adjusted.

Explanation of Provision

The provision clarifies the rules of section 845, relating to authority for the Treasury Secretary to allocate items among the parties to a reinsurance agreement, recharacterize items, or make any other adjustment, in order to reflect the proper source and character of the items for each party. The proposal authorizes such allocation, recharacterization, or other adjustment, in order to reflect the proper source, character or amount of the item. It is intended that this authority[199] 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.

C. Effectively connected income to include certain foreign source income (sec. 345 of the bill and sec. 864(c) of the Code)

Present Law

Nonresident alien individuals and foreign corporations (collectively, foreign persons) are subject to U.S. tax on income that is effectively connected with the conduct of a U.S. trade or business; the U.S. tax on such income is calculated in the same manner and at the same graduated rates as the tax on U.S. persons.[200] Foreign persons also are subject to a 30-percent gross-basis tax, collected by withholding, on certain U.S.-source income, such as interest, dividends and other fixed or determinable annual or periodical ("FDAP") income, that is not effectively connected with a U.S. trade or business. This 30-percent withholding tax may be reduced or eliminated pursuant to an applicable tax treaty. Foreign persons generally are not subject to U.S. tax on foreign-source income that is not effectively connected with a U.S. trade or business.

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

[200] Sections 871(b) and 882.

Detailed rules apply for purposes of determining whether income is treated as effectively connected with a U.S. trade or business (so-called "U.S.-effectively connected income").[201] The rules differ depending on whether the income at issue is U.S-source or foreign-source income. Under these rules, U.S.-source FDAP income, such as U.S.-source interest and dividends, and U.S.-source capital gains are treated as U.S.-effectively connected income if such income is derived from assets used in or held for use in the active conduct of a U.S. trade or business, or from business activities conducted in the United States. All other types of U.S.-source income are treated as U.S.-effectively connected income (sometimes referred to as the "force of attraction rule").

In general, foreign-source income is not treated as U.S.-effectively connected income.[202] However, foreign-source income, gain, deduction, or loss generally is considered to be effectively connected with a U.S. business only if the person has an office or other fixed place of business within the United States to which such income, gain, deduction, or loss is attributable and such income falls into one of three categories described below.[203] For these purposes, income generally is not considered attributable to an office or other fixed place of business within the United States unless such office or fixed place of business is a material factor in the production of the income, and such office or fixed place of business regularly carries on activities of the type that generate such income.[204]

The first category consists of rents or royalties for the use of patents, copyrights, secret processes, or formulas, good will, trademarks, trade brands, franchises, or other like intangible properties derived in the active conduct of the U.S. trade or business.[205] The second category consists of interest or dividends derived in the active conduct of a banking, financing, or similar business within the United States, or received by a corporation whose principal business is trading in stocks or securities for its own account.[206] Notwithstanding the foregoing, foreign-source income consisting of dividends, interest, or royalties is not treated as effectively connected if the items are paid by a foreign corporation in which the recipient owns, directly, indirectly, or constructively, more than 50 percent of the total combined voting power of the stock.[207] The third category consists of income, gain, deduction, or loss derived from the sale or exchange of inventory or property held by the taxpayer primarily for sale to customers in the ordinary course of the trade or business where the property is sold or exchanged outside the

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[201] Section 864(c).

[202] Section 864(c)(4).

[203] Section 864(c)(4)(B).

[204] Section 864(c)(5).

[205] Section 864(c)(4)(B)(i).

[206] Section 864(c)(4)(B)(ii).

[207] Section 864(c)(4)(D)(i).

United States through the foreign person's U.S. office or other fixed place of business.[208] Such amounts are not treated as effectively connected if the property is sold or exchanged for use, consumption, or disposition outside the United States and an office or other fixed place of business of the taxpayer in a foreign country materially participated in the sale or exchange.

The Code provides sourcing rules for enumerated types of income, including interest, dividends, rents, royalties, and personal services income.[209] For example, interest income generally is sourced based on the residence of the obligor. Dividend income generally is sourced based on the residence of the corporation paying the dividend. Thus, interest paid on obligations of foreign persons and dividends paid by foreign corporations generally are treated as foreign-source income.

Other types of income are not specifically covered by the Code's sourcing rules. For example, fees for accepting or confirming letters of credit have been sourced under principles analogous to the interest sourcing rules.[210] In addition, under regulations, payments in lieu of dividends and interest derived from securities lending transactions are sourced in the same manner as interest and dividends, including for purposes of determining whether such income is effectively connected with a U.S. trade or business.[211] Moreover, income from notional principal contracts (such as interest rate swaps) generally is sourced based on the residence of the recipient of the income.[212]

Reasons for Change

The Committee believes that present law creates arbitrary distinctions between economically similar transactions that are equally related to a U.S. trade or business. The Committee believes that the rules for determining whether income that is economically equivalent to certain types of foreign-source income (e.g., interest and dividends) that are treated as U.S.-effectively connected income should be the same as the rules for determining whether such foreign-source income is U.S.-effectively connected income.

Explanation of Provision

Each category of foreign-source income that is treated as effectively connected with a U.S. trade or business is expanded to include economic equivalents of such income (i.e., economic equivalents of certain foreign-source (1) rents and royalties, (2) dividends and interest, and (3) income on sales or exchanges of goods in the ordinary course of business). Thus, such economic equivalents are treated as U.S.-effectively connected income in the same

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[208] Section 864(c)(4)(B)(iii).

[209] Sections 861 through 865.

[210] See Bank of America v. United States, 680 F.2d 142 (Ct. Cl. 1982).

[211] Treas. Reg. sec. 1.864-5(b)(2)(ii).

[212] Treas. Reg. sec. 1.863-7.

circumstances that foreign-source rents, royalties, dividends, interest, or certain inventory sales are treated as U.S.-effectively connected income. For example, foreign-source interest and dividend equivalents are treated as U.S.-effectively connected income if the income is attributable to a U.S. office of the foreign person, and such income is derived by such foreign person in the active conduct of a banking, financing, or similar business within the United States, or the foreign person is a corporation whose principal business is trading in stocks or securities for its own account.

Effective date

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

D. Determination of Basis Amounts Paid from Foreign Pension Plans (sec. 346 of the bill and sec. 72 of the Code)

Present Law

Distributions from retirement plans are includible in gross income under the rules relating to annuities[213] and, thus, are generally includible in income, except to the extent the amount received represents investment in the contract (i.e., the participant's basis). The participant's basis includes amounts contributed by the participant, together with certain amounts contributed by the employer, minus the aggregate amount (if any) previously distributed to the extent that such amount was excludable from gross income. Amounts contributed by the employer are included in the calculation of the participant's basis to the extent that such amounts were includible in the gross income of the participant, or to the extent that such amounts would have been excludable from the participant's gross income if they had been paid directly to the participant at the time they were contributed.

Distributions received by nonresidents from U.S. qualified plans and similar arrangements are generally subject to tax to the extent that the amount received is otherwise includible in gross income (i.e., is in excess of the basis) and is from a U.S. source. Employer contributions to qualified plans and other payments for services performed outside the United States generally are not treated as income from a U.S. source, and therefore generally are not subject to U.S. tax.

Under the 1996 U.S. model income tax treaty and many U.S. income tax treaties in force, pension distributions beneficially owned by a resident of a treaty country in consideration for past employment generally are taxable only by the individual recipient's country of residence.[214] Under the 1996 U.S. model income tax treaty and some U.S. income tax treaties, this exclusive residence-based taxation rule is limited to the taxation of amounts that were not previously included in taxable income in the other country. For example, if a treaty country had imposed tax on a resident individual with respect to some portion of a pension plan's earnings, subsequent

[213] Sections 72 and 402.

[214] Some treaties permit source-country taxation but merely reduce the rate of tax imposed on pension benefits.

distributions to a resident of the other country would not be taxable in that country to the extent the distributions were attributable to such amounts.

Reasons for Change

The Committee believes the present-law rules governing the calculation of basis provide an inflated basis in pension assets for many individuals who become U.S. residents after accruing benefits under foreign pension plans. The Committee believes the ability of former nonresidents to receive tax-free distributions from foreign pension plans under present law is inconsistent with the taxation of retirement benefits paid to individuals who both accrue and receive distributions of qualified plan benefits as U.S. residents (*i.e.*, basis generally includes only previously-taxed amounts). The Committee believes it is necessary to provide more equitable taxation of retirement plan distributions.

Explanation of Provision

An amount distributed from a foreign pension plan is included in the calculation of the recipient's basis only to the extent that the recipient previously has been subject to taxation, either in the United States or the foreign jurisdiction, on such amount.

Effective date

The provision is effective for distributions occurring on or after the date of enactment.

E. Prevention of Mismatching of Interest and Original Issue Discount Deductions and Income Inclusions in Transactions with Related Foreign Persons (sec. 348 of the bill and secs. 163 and 267 of the Code)

Present Law

Income earned by a foreign corporation from its foreign operations generally is subject to U.S. tax only when such income is distributed to any U.S. person that holds stock in such corporation. Accordingly, a U.S. person that conducts foreign operations through a foreign corporation generally is subject to U.S. tax on the income from such operations when the income is repatriated to the United States through a dividend distribution to the U.S. person. The income is reported on the U.S. person's tax return for the year the distribution is received, and the United States imposes tax on such income at that time. However, certain anti-deferral regimes may cause the U.S. person to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by the foreign corporations in which the U.S. person holds stock. The main anti-deferral regimes are the controlled foreign corporation rules of subpart F (sections 951-964), the passive foreign investment company rules (sections 1291-1298), and the foreign personal holding company rules (sections 551-558).

As a general rule, there is allowed as a deduction all interest paid or accrued within the taxable year with respect to indebtedness, including the aggregate daily portions of original issue discount ("OID") of the issuer for the days during such taxable year. However, if a debt instrument is held by a related foreign person, any portion of such OID is not allowable as a deduction to the payor of such instrument until paid ("related-foreign-person rule"). This related-foreign-person rule does not apply to the extent that the OID is effectively connected with the conduct by such foreign related person of a trade or business within the United States (unless such OID is exempt from taxation or is subject to a reduced rate of taxation under a treaty obligation). Treasury regulations further modify the related-foreign-person rule by providing that in the case of a debt owed to a foreign personal holding company ("FPHC"), controlled foreign corporation ("CFC") or passive foreign investment company ("PFIC"), a deduction is allowed for OID as of the day on which the amount is includible in the income of the FPHC, CFC or PFIC, respectively.

In the case of unpaid stated interest and expenses of related persons, where, by reason of a payee's method of accounting, an amount is not includible in the payee's gross income until it is paid but the unpaid amounts are deductible currently by the payor, the amount generally is allowable as a deduction when such amount is includible in the gross income of the payee. With respect to stated interest and other expenses owed to related foreign corporations, Treasury regulations provide a general rule that requires a taxpayer to use the cash method of accounting with respect to the deduction of amounts owed to such related foreign persons (with an exception for income of a related foreign person that is effectively connected with the conduct of a U.S. trade or business and that is not exempt from taxation or subject to a reduced rate of taxation under a treaty obligation). As in the case of OID, the Treasury regulations additionally provide that in the case of states interest owed to a FPHC, CFC, or PFIC, a deduction is allowed as of the day on which the amount is includible in the income of the FPHC, CFC or PFIC.

Reasons for Change

The special rules in the Treasury regulations for FPHCs, CFCs and PFICs are an exception to the general rule in those regulations that OID and unpaid interest owed to a related foreign person are deductible when paid (*i.e.*, under a cash method). These special rules were deemed appropriate in the case of FPHCs, CFCs and PFICs because it was thought that there would be little material distortion in matching of income and deductions with respect to amounts owed to a related foreign corporation that is required to determine its taxable income and earnings and profits for U.S. tax purposes pursuant to the FPHC, subpart F or PFIC provisions. This premise fails to take into account the situation where amounts owed to the related foreign corporation are included in the income of the related foreign corporation but are not currently included in the income of the related foreign corporation's U.S. shareholders. Consequently, under the Treasury regulations, both U.S. payors and U.S.-owned foreign payors may be able to accrue deductions for amounts owed to related FPHCs, CFCs or PFICs without the U.S. owners of such related entities taking into account for U.S. tax purposes a corresponding amount of income. These deductions can be used to reduce U.S. income or, in the case of a U.S.-owned foreign payor, to reduce earnings and profits which, for example, could reduce a CFC's income that would be currently taxable to its U.S. shareholders under subpart F.

Explanation of Provision

The provision provides that deductions for amounts accrued but unpaid (whether by U.S. or foreign persons) to related FPHCs, CFCs, or PFICs are allowable only to the extent that the amounts accrued by the payor are, for U.S. tax purposes, currently included in the income of the direct or indirect U.S. owners of the related foreign person. Deductions that have accrued but are not allowable under this provision are allowed when the amounts are paid. The provision provides an exception for amounts accrued where payment of the amount accrued occurs within a short period after accrual, and the transaction giving rise to the payment is entered into by the payor in the ordinary course of a business in which the payor is predominantly engaged. In addition, the provision grants the Secretary regulatory authority to provide exceptions to these rules.

Effective Date

The provision is effective for payments accrued on or after May 8, 2003.

F. Doubling of Certain Penalties, Fines, and Interest on Underpayments Related to Certain Offshore Financial Arrangements (sec. 344 of the bill)

Present Law

In general

The Code contains numerous civil penalties, such as the delinquency, accuracy-related and fraud penalties. These civil penalties are in addition to any interest that may be due as a result of an underpayment of tax. If all or any part of a tax is not paid when due, the Code imposes interest on the underpayment, which is assessed and collected in the same manner as the underlying tax and is subject to the same statute of limitations.

Delinquency penalties

Failure to file. Under present law, a taxpayer who fails to file a tax return on a timely basis is generally subject to a penalty equal to 5 percent of the net amount of tax due for each month that the return is not filed, up to a maximum of five months or 25 percent. An exception from the penalty applies if the failure is due to reasonable cause. The net amount of tax due is the excess of the amount of the tax required to be shown on the return over the amount of any tax paid on or before the due date prescribed for the payment of tax.

Failure to pay. Taxpayers who fail to pay their taxes are subject to a penalty of 0.5 percent per month on the unpaid amount, up to a maximum of 25 percent. If a penalty for failure to file and a penalty for failure to pay tax shown on a return both apply for the same month, the amount of the penalty for failure to file for such month is reduced by the amount of the penalty for failure to pay tax shown on a return. If a return is filed more than 60 days after its due date, then the penalty for failure to file tax shown on a return may not reduce the penalty for failure to pay below the lesser of $100 or 100 percent of the amount required to be shown on the return. For any month in which an installment payment agreement with the IRS is in effect, the rate of the penalty is half the usual rate (0.25 percent instead of 0.5 percent), provided that the taxpayer filed the tax return in a timely manner (including extensions).

Failure to make timely deposits of tax. The penalty for the failure to make timely deposits of tax consists of a four-tiered structure in which the amount of the penalty varies with the length of time within which the taxpayer corrects the failure. A depositor is subject to a penalty equal to 2 percent of the amount of the underpayment if the failure is corrected on or before the date that is five days after the prescribed due date. A depositor is subject to a penalty equal to 5 percent of the amount of the underpayment if the failure is corrected after the date that is five days after the prescribed due date but on or before the date that is 15 days after the prescribed due date. A depositor is subject to a penalty equal to 10 percent of the amount of the underpayment if the failure is corrected after the date that is 15 days after the due date but on or before the date that is 10 days after the date of the first delinquency notice to the taxpayer (under sec. 6303). Finally, a depositor is subject to a penalty equal to 15 percent of the amount of the underpayment if the failure is not corrected on or before the date that is 10 days after the date of the day on which notice and demand for immediate payment of tax is given in cases of jeopardy.

An exception from the penalty applies if the failure is due to reasonable cause. In addition, the Secretary may waive the penalty for an inadvertent failure to deposit any tax by specified first-time depositors.

Accuracy-related penalties

The accuracy-related penalty is imposed at a rate of 20 percent of the portion of any underpayment that is attributable, in relevant, to (1) negligence, (2) any substantial understatement of income tax and (3) any substantial valuation misstatement. In addition, the penalty is doubled for certain gross valuation misstatements. These consolidated penalties are also coordinated with the fraud penalty. This statutory structure operates to eliminate any stacking of the penalties.

No penalty is to be imposed if it is shown that there was reasonable cause for an underpayment and the taxpayer acted in good faith. However, Treasury has issued proposed regulations 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.

Negligence or disregard for the rules or regulations. If an underpayment of tax is attributable to negligence, the negligence penalty applies only to the portion of the underpayment that is attributable to negligence. Negligence any failure to make a reasonable attempt to comply with the provisions of the Code. Disregard includes any careless, reckless or intentional disregard of the rules or regulations.

Substantial understatement of income tax. Generally, an understatement is substantial if the understatement exceeds the greater of (1) 10 percent of the tax required to be shown on the return for the tax year or (2) $5,000. In determining whether a substantial understatement exists, the amount of the understatement is reduced by any portion attributable to an item if (1) the treatment of the item on the return is or was supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed on the return or on a statement attached to the return.

Substantial valuation misstatement. A penalty applies to the portion of an underpayment that is attributable to a substantial valuation misstatement. Generally, a substantial valuation misstatement exists if the value or adjusted basis of any property claimed on a return is 200 percent or more of the correct value or adjusted basis. The amount of the penalty for a substantial valuation misstatement is 20 percent of the amount of the underpayment if the value or adjusted basis claimed is 200 percent or more but less than 400 percent of the correct value or adjusted basis. If the value or adjusted basis claimed is 400 percent or more of the correct value or adjusted basis, then the overvaluation is a gross valuation misstatement.

Gross valuation misstatements. The rate of the accuracy-related penalty is doubled (to 40 percent) in the case of gross valuation misstatements.

Fraud penalty

The fraud penalty is imposed at a rate of 75 percent of the portion of any underpayment that is attributable to fraud. The accuracy-related penalty does not to apply to any portion of an underpayment on which the fraud penalty is imposed.

Interest Provisions

Taxpayers are required to pay interest to the IRS whenever there is an underpayment of tax. An underpayment of tax exists whenever the correct amount of tax is not paid by the last date prescribed for the payment of the tax. The last date prescribed for the payment of the income tax is the original due date of the return.

Different interest rates are provided for the payment of interest depending upon the type of taxpayer, whether the interest relates to an underpayment or overpayment, and the size of the underpayment or overpayment. Interest on underpayments is compounded daily.

Offshore Voluntary Compliance Initiative

In January 2003, Treasury announced the Offshore Voluntary Compliance Initiative ("OVCI") to encourage the voluntary disclosure of previously unreported income placed by taxpayers in offshore accounts and accessed through credit card or other financial arrangements. A taxpayer had to comply with various requirements in order to participate in OVCI, including sending a written request to participate in the program by April 15, 2003. This request had to include information about the taxpayer, the taxpayer's introduction to the credit card or other financial arrangements and the names of parties that promoted the transaction. Taxpayers eligible under OVCI will not be liable for civil fraud, the fraudulent failure to file penalty or the civil information return penalties. The taxpayer will pay back taxes, interest and certain accuracy-related and delinquency penalties.

Reasons for Change

The Committee is aware that individuals and corporations, through sophisticated transactions, are placing unreported income in offshore financial accounts accessed through credit or debit cards or other financial arrangements in order to avoid or evade Federal income tax. Such a phenomenon poses a serious threat to the efficacy of the tax system because of both the potential loss of revenue and the potential threat to the integrity of the self-assessment system. The IRS estimates there may be several hundred thousand taxpayers using offshore financial arrangements to conceal taxable income from the IRS costing the government billions of dollars in lost revenue. Under the OVCI initiative, only 1,253 taxpayers from 46 states stepped forward to participate in the program. From these cases, the IRS expects to identify at least $100 million in uncollected tax. At the start of the program, the clear message to taxpayers was that those who failed to come forward would be pursued by the IRS and would be subject to more significant penalties and possible criminal sanctions. The Committee believes that doubling the civil penalties, fines and interest applicable to taxpayers who entered in to these arrangements and did not take advantage of OVCI will provide the IRS with the significant sanctions needed to stem the promotion and participation in these abusive schemes.

Explanation of Provision

The provision would increase the total amount of civil penalties, interest and fines applicable by a factor of two for taxpayers who would have been eligible to participate in OVCI but did not participate in the program.

Effective Date

The bill generally is effective with respect to a taxpayer's open tax years on or after May 8, 2000.

G. Repeal of earned income exclusion for citizens or residents living abroad (sec. 350 of the bill and sec. 911 of the Code)

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.

Reasons for Change

The Committee believes that the exclusions under section 911 may result in an unfair advantage for individuals who have moved to lower-tax foreign countries, in that such individuals are taxed at a lower global effective rate than similarly situated individuals living and working in the United States. The Committee believes that U.S. citizens living and working abroad still receive the benefits of U.S. citizenship and thus should pay U.S. tax on their foreign income, subject to the normally applicable foreign tax credit rules.

Explanation of Provision

The exclusion for foreign earned income and the exclusion or deduction for housing expenses are repealed.

Effective Date

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

H. Sale of Gasoline and Diesel Fuel at Duty-Free Sales Enterprises (sec. 349 of the bill)

Present Law

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

Reasons for Change

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

Explanation of Provision

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

Effective Date

The provision is effective on the date of enactment.

I. Recapture of Overall Foreign Losses on Sale of Controlled Foreign Corporation Stock (sec. 347 of the bill and sec. 904(f) of the Code)

Present Law

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. The amount of foreign tax credits generally is limited to the portion of the taxpayer's U.S. tax which the taxpayer's foreign-source taxable income (i.e., foreign-source gross income less allocable expenses or deductions) bears to the taxpayer's worldwide taxable income for the year.[215] Separate limitations are applied to specific categories of income.

Special recapture rules apply in the case of foreign losses for purposes of applying the foreign tax credit limitation.[216] Under these rules, losses for any taxable year in a limitation category which exceed the aggregate amount of foreign income earned in other limitation categories (a so-called "overall foreign loss") are recaptured by resourcing foreign-source income earned in a subsequent year as U.S.-source income.[217] The amount resourced as U.S.-source income generally is limited to the lesser of the amount of the overall foreign losses not previously recaptured, or 50 percent of the taxpayer's

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215 Section 904(a).

216 Section 904(f).

217 Section 904(f)(1).

foreign-source income in a given year (the “50-percent limit”). Taxpayers may elect to recapture a larger percentage of such losses.

A special recapture rule applies to ensure the recapture of an overall foreign loss where property which was used in a trade or business predominantly outside the United States is disposed of prior to the time the loss has been recaptured.[218] In this regard, dispositions of trade or business property used predominantly outside the United States are treated as having been recognized as foreign-source income (regardless of whether gain would otherwise be recognized upon disposition of the assets), in an amount equal to the lesser of the excess of the fair market value of such property over its adjusted basis, or the amount of unrecaptured overall foreign losses. Such foreign-source income is resourced as U.S.-source income without regard to the 50-percent limit. For example, if a U.S. corporation transfers its foreign branch business assets to a foreign corporation in a nontaxable section 351 transaction, the taxpayer would be treated for purposes of the recapture rules as having recognized foreign-source income in the year of the transfer in an amount equal to the excess of the fair market value of the property disposed over its adjusted basis (or the amount of unrecaptured foreign losses, if smaller). Such income would be recaptured as U.S.-source income to the extent of any prior unrecaptured overall foreign losses.[219]

Detailed rules apply in allocating and apportioning deductions and losses for foreign tax credit limitation purposes. In the case of interest expense, such amounts generally are apportioned to all gross income under an asset method, under which the taxpayer's assets are characterized as producing income in statutory or residual groupings (i.e., foreign-source income in the various limitation categories or U.S.-source income).[220] Interest expense is apportioned among these groupings based on the relative asset values in each. Taxpayers may elect to value assets based on either tax book value or fair market value.

Each corporation that is a member of an affiliated group is required to apportion its interest expense using apportionment fractions determined by reference to all assets of the affiliated group. For this purpose, an affiliated group generally is defined to include only domestic corporations. Stock in a foreign subsidiary, however, is treated as a foreign asset that may attract the allocation of U.S. interest expense for these purposes. If tax basis is used to value assets, the adjusted basis of the stock of certain 10-percent or greater owned foreign corporations or other non-affiliated corporations must be increased by the amount of earnings and profits of such corporation accumulated during the period the U.S. shareholder held the stock.

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[218] Section 904(f)(3).

[219] Coordination rules apply in the case of losses recaptured under the branch loss recapture rules. Section 367(a)(3)(C).

[220] Section 864(e) and Temp. Treas. Reg. sec. 1.861-9T.

Reasons for Change

The Committee believes that dispositions of corporate stock should be subject to the special recapture rules for overall foreign losses. Ownership of stock in a foreign subsidiary can lead to, or increase, an overall foreign loss as a result of interest expenses allocated against foreign-source income under the interest expense allocation rules. The recapture of overall foreign losses created by such interest expense allocations may be avoided if, for example, the stock of the foreign subsidiary subsequently were transferred to unaffiliated parties in non-taxable transactions. The Committee believes that overall foreign losses should be recaptured when stock of a controlled foreign corporation is disposed, regardless of whether such stock is disposed in a non-taxable transaction.

Explanation of Provision

The special recapture rule for overall foreign losses that currently applies to dispositions of foreign trade or business assets is to apply to the disposition of controlled foreign corporation stock. Thus, dispositions of controlled foreign corporation stock are recognized as foreign-source income in an amount equal to the lesser of the fair market value of the stock over its adjusted basis, or the amount of prior unrecaptured overall foreign losses. Such income is resourced as U.S.-source income for foreign tax credit limitation purposes without regard to the 50-percent limit.

Effective date

The provision is effective as of the date of enactment.

SUBTITLE E – OTHER REVENUE PROVISIONS

A. Extension of IRS User Fees
(sec. 351 of the bill and new sec. 7529 of the Code)

Present Law

The IRS provides written responses to questions of individuals, corporations, and organizations relating to their tax status or the effects of particular transactions for tax purposes. The IRS generally charges a fee for requests for a letter ruling, determination letter, opinion letter, or other similar ruling or determination. Public Law 104-117[221] extended the statutory authorization for these user fees[222] through September 30, 2003.

Reasons for Change

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

Explanation of Provision

The bill extends the statutory authorization for these user fees through September 30, 2013. The bill also moves the statutory authorization for these fees into the Code.[223]

Effective Date

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

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[221] 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).

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

[223] 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).

B. Add Vaccines Against Hepatitis A to the List of Taxable Vaccines (sec. 352 of the bill and sec. 4132 of the Code)

Present Law

A manufacturer's excise tax is imposed at the rate of 75 cents per dose[224] on the following vaccines routinely recommended for administration to children: diphtheria, pertussis, tetanus, measles, mumps, rubella, polio, HIB (haemophilus influenza type B), hepatitis B, varicella (chicken pox), rotavirus gastroenteritis, and streptococcus pneumoniae. The tax applied to any vaccine that is a combination of vaccine components equals 75 cents times the number of components in the combined vaccine.

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

Reasons for Change

The Committee is aware that the Centers for Disease Control and Prevention have recommended that children in 17 highly endemic States be inoculated with a hepatitis A vaccine. The population of children in the effected States exceeds 20 million. Several of the effected States mandate childhood vaccination against hepatitis A. The Committee is aware that the Advisory Commission on Childhood Vaccines has recommended that the vaccine excise tax be extended to cover vaccines against hepatitis A. For these reasons, the Committee believes it is appropriate to include vaccines against hepatitis A as part of the Vaccine Injury Compensation Program. Making the hepatitis A vaccine taxable is a first step.[225] In the unfortunate event of an injury related to this vaccine, families of injured children are eligible for the no-fault arbitration system established under the Vaccine Injury Compensation Program rather than going to Federal Court to seek compensatory redress.

Explanation of Provision

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

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[224] Sec. 4131.

[225] The Committee recognizes that, to become covered under the Vaccine Injury Compensation Program, the Secretary of Health and Human Services also must list the hepatitis A vaccine on the Vaccine Injury Table.

Effective Date

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

C. Disallowance of Certain Partnership Loss Transfers (sec. 353 of the bill and secs. 704, 734, and 743 of the Code)

Present Law

Contributions of property

Under present law, if a partner contributes property to a partnership, no gain or loss generally is recognized to the contributing partner at the time of contribution.[226] The partnership takes the property at an adjusted basis equal to the contributing partner's adjusted basis in the property.[227] The contributing partner increases its basis in its partnership interest by the adjusted basis of the contributed property.[228] 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.[229] 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.[230]

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.[231] 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

[226] Sec. 721.

[227] Sec. 723.

[228] Sec. 722.

[229] Sec. 704(c)(1)(A).

[230] 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).

[231] Treas. Reg. 1.704-3(a)(7).

election under section 754 to make basis adjustments.[232] 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 transferee's basis in its partnership interest.[233] 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 certain partnership property without recognition of gain or loss by either the partner or the partnership.[234] 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).[235] 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).[236]

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.[237] 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 (or gain or loss recognized by the disributee partner).[238] 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

[232] Sec. 743(a).

[233] Sec. 743(b).

[234] Sec. 731(a) and (b).

[235] Sec. 732(b).

[236] Sec. 732(a).

[237] Sec. 734(a).

[238] Sec. 734(b).

adjusted basis of all partnership property and leave the remaining partners with a smaller net built-in gain or a larger net built-in loss than before the distribution.

Reasons for Change

The Committee believes that the partnership rules currently allow for the inappropriate transfer of losses among partners. This has allowed partnerships to be created and used to aid tax-shelter transactions.

The bill limits the ability to transfer losses among partners, while preserving the simplification aspects of the current partnership rules for transactions involving smaller amounts.

Explanation of Provision

Contributions of property

Under the provision, a built-in loss may be taken into account only by the contributing partner and not by other partners. Except as provided in regulations, in determining the amount of items allocated to partners other than the contributing partner, the basis of the contributed property is treated as the fair market value 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.[239]

Transfers of partnership interests

The provision provides that the basis adjustment rules under section 743 are mandatory in the case of the transfer of a partnership interest with respect to which there is a substantial 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.

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 values.

Distribution of partnership property

The provision provides that a basis adjustment under section 734(b) is required in the case of a distribution with respect to which there is a substantial basis reduction. A substantial

[239] 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.

basis reduction means a downward adjustment of more that $250,000 that would be made to the basis of partnership assets if a section 754 election were in effect.

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

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

D. Treatment of Stripped Bonds to Apply to Stripped Interests in Bond and Preferred Stock Funds (sec. 354 of the bill and secs. 305 and 1286 of the Code)

Present Law

Assignment of income in general

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

Common law has developed a rule (referred to as the "assignment of income" doctrine) 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.[240]

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

[240] *Helvering v. Horst*, 311 U.S. 112 (1940).

transactions involving stripped bonds and stripped preferred stock (which are discussed below).[241] However, there are no specific statutory rules that address stripping transactions with respect to common stock or other equity interests (other than preferred stock).[242]

Stripped bonds

Special rules are provided with respect to the purchaser and "stripper" of stripped bonds.[243] 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.[244] 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.[245] 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

[241] 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).

[242] 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.

[243] Sec. 1286.

[244] Sec. 1286(e).

[245] Sec. 1286(a).

the coupons attached) between the retained and disposed items.[246] Special rules apply to require that interest or market discount accrued on the bond prior to such disposition must be included in the taxpayer's gross income (to the extent that it had not been previously included in income) at the time the stripping occurs, and the taxpayer increases his basis in the bond by the amount of such accrued interest or market discount. The adjusted basis (as increased by any accrued interest or market discount) is then allocated between the stripped bond and the stripped interest coupons in relation to their respective fair market values. Amounts realized from the sale of stripped coupons or bonds constitute income to the taxpayer only to the extent such amounts exceed the basis allocated to the stripped coupons or bond. With respect to retained items (either the detached coupons or stripped bond), to the extent that the price payable on maturity, or on the due date of the coupons, exceeds the portion of the taxpayer's basis allocable to such retained items, the difference is treated as OID that is required to be included under the general OID periodic income inclusion rules.[247]

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.[248] 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.[249] 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.[250]

Reasons for Change

The Committee is concerned that taxpayers are entering into tax avoidance transactions to generate artificial losses, or defer the recognition of ordinary income and convert such income into capital gains, by selling or purchasing stripped interests that are not subject to the present-law rules relating to stripped bonds and preferred stock but that represent interests in bonds or

[246] Sec. 1286(b). Similar rules apply in the case of any person whose basis in any bond or coupon is determined by reference to the basis in the hands of a person who strips the bond.

[247] 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)).

[248] Sec. 305(e)(5).

[249] Sec. 305(e)(1).

[250] Sec. 305(e)(3).

preferred stock. Therefore, the Committee believes that it is appropriate to provide Treasury with regulatory authority to apply such rules to interests that do not constitute bonds or preferred stock but nevertheless derive their economic value and characteristics exclusively from underlying bonds or preferred stock.

Explanation of Provision

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

For example, such Treasury regulations could apply to a transaction in which a person effectively strips future dividends from shares in a money market mutual fund (and disposes either the stripped shares or stripped future dividends) by contributing the shares (with the future dividends) to a custodial account through which another person purchases rights to either the stripped shares or the stripped future dividends. However, it is intended that Treasury regulations issued under this provision would not apply to certain transactions involving direct or indirect interests in an entity or account substantially all the assets of which consist of tax-exempt obligations (as defined in section 1275(a)(3)), such as a tax-exempt bond partnership described in Rev. Proc. 2002-68,[251] *modifying and superceding* Rev. Proc. 2002-16.[252]

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

Effective Date

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

[251] 2002-43 I.R.B. 753.

[252] 2002-9 I.R.B. 572.

E. Reporting of taxable mergers and acquisitions (sec. 355 of the bill and new sec. 6043A of the Code)

Present Law

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

Reasons for Change

The Committee believes that tax administration would be improved by expanding reporting requirements with respect to taxable transactions other than exchanges for cash.

Description of Provision

Under the provision, 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 provision is effective for acquisitions after the date of enactment of the proposal.

F. Minimum Holding Period for Foreign Tax Credit Wth Repect to Withholding Taxes on Income Other Than Dividends (sec. 356 of the bill and sec. 901 of the Code)

Present Law

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

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

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

Reasons for Change

The Committee believes that the present-law holding period requirement for claiming foreign tax credits with respect to dividends is too narrow in scope and, in general, should be extended to apply to items of income or gain other than dividends, such as interest.

Explanation of Provision

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

Effective Date

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

G. Qualified Tax Collection Contract
(sec. 357 of the bill and new sec. 6306 of the Code)

Present Law

In fiscal years 1996 and 1997, the Congress earmarked $13 million for IRS to test the use of private debt collection companies. There were several constraints on this pilot project. First, because both IRS and OMB considered the collection of taxes to be an inherently governmental function, only government employees were permitted to collect the taxes.[253] 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[254] 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.

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[253] Sec. 7801(a).

[254] GAO/GGD-97-129R Issues Affecting IRS' Collection Pilot (July 18, 1997).

The IRS has in the last several years expressed renewed interest in the possible use of private debt collection companies; for example, IRS recently revised its extensive Request for Information concerning its possible use of private debt collection companies.[255]

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.[256] That provision does not apply to the collection of debts under the Internal Revenue Code.[257]

On February 3, 2003, the President submitted to the Congress his fiscal year 2004 budget proposal,[258] which proposed the use of private debt collection companies to collect Federal tax debts.

Reasons for Change

The IRS reports that it currently has $75.7 billion in uncollected receivables,[259] owed by over 6.1 million individuals and businesses.[260] The Committee believes that it is vital to the functioning of the tax system that more effort be made to collect this debt. The Committee believes that utilizing private sector debt collection agencies, which have considerable experience in collecting non-tax debt owed to the Government, will significantly aid in this collection effort. The Committee has designed this program so that it: (1) is limited in scope; (2) is specific and does not permit the exercise of discretionary authority; and (3) does not encompass enforcement actions. The Committee believes that these features will permit maximum utilization of this private sector expertise consistent with sound tax administration and sound constitutional principles.

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

[256] 31 U.S.C. sec. 3718.

[257] 31 U.S.C. sec. 3718(f).

[258] *See* Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2004* (H. Doc. 108-3, Vol. I), p. 274.

[259] This is the dollar value of what the IRS calls the "Potentially Collectible Inventory;" it excludes amounts deemed to be uncollectible or duplicative assessments.

[260] TIRNO-03-H-0001 (February 14, 2003), at www.procurement.irs.treas.gov. Attachment #3.

Explanation of Provision

The proposal permits the IRS to use private debt collection companies to locate and contact taxpayers owing outstanding tax liabilities[261] of any type[262] 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.[263] If the taxpayer's last known address is incorrect, the private debt collection 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.[264] If the taxpayer cannot pay in full immediately, the private debt collection company offers the taxpayer an installment agreement providing for full payment of the taxes over a period of as long as 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 provision specifies several procedural conditions under which the provision would operate. First, provisions of the Fair Debt Collection Practices Act apply to the private debt collection company. Second, taxpayer protections that are statutorily applicable to the IRS are also made statutorily applicable to the private sector debt collection companies. Third, the private sector debt collection companies are required to inform taxpayers of the availability of assistance from the Taxpayer Advocate.

The provision creates a revolving fund from the amounts collected by the private debt collection companies. The private debt collection companies would be paid out of this fund.

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[261] There must be an assessment pursuant to section 6201 in order for there to be an outstanding tax liability.

[262] The proposal generally applies to any type of tax imposed under the Internal Revenue Code. The Committee anticipates that the focus in implementing the provision will be: (a) taxpayers who have filed a return showing a balance due but who have failed to pay that balance in full; and (b) taxpayers who have been assessed additional tax by the IRS and who have made several voluntary payments toward satisfying their obligation but have not paid in full.

[263] Several portions of the provision require that the IRS disclose confidential taxpayer information to the private debt collection company. Section 6103(n) permits disclosure for "the providing of other services ... for purposes of tax administration." Accordingly, no amendment to 6103 is necessary to implement the provision. The Committee intends, however, that the IRS vigorously protect the privacy of confidential taxpayer information by disclosing the least amount of information possible to contractors consistent with the effective operation of the provision.

[264] The private debt collection company is not permitted to accept payment directly. Payments are required to be processed by IRS employees.

The provision prohibits the payment of fees for all services in excess of 25 percent of the amount collected under a tax collection contract.[265]

Effective Date

The provision is effective on the date of enactment.

H. Extension of Customs User Fees (sec. 358 of the bill)

Present Law

Section 13031 of the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) (P.L. 99-272), authorized the Secretary of the Treasury to collect certain service fees. Section 412 (P.L 107-296) of the Homeland Security Act of 2002 authorized the Secretary of the Treasury to delegate such authority to the Secretary of Homeland Security. Provided for under 19 U.S.C. 58c, these fees include: processing fees for air and sea passengers, commercial trucks, rail cars, private aircraft and vessels, commercial vessels, dutiable mail packages, barges and bulk carriers, merchandise, and Customs broker permits. COBRA was amended on several occasions but most recently by P.L. 103-182 which extended authorization for the collection of these fees through fiscal year 2003.

Reasons for Change

The Committee authorizes the continued collection of COBRA fees through December 31, 2013.

Explanation of Provision

The bill extends the fees authorized under the Consolidated Omnibus Budget Reconciliation Act of 1985 through December 31, 2013.

Effective Date

The provision is effective on the date of enactment.

[265] It is assumed that there will be competitive bidding for these contracts by private sector tax collection agencies and that vigorous bidding will drive the overhead costs down.

I. Modify Qualification Rules for Tax-Exempt Property and Casualty Insurance Companies (sec. 359 of the bill and secs. 501(c)(15) and 831(b) of the Code)

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 (which ever 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 threshhold 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).

Reasons for Change

The Committee has become aware of abuses in the area of tax-exempt insurance companies. Considerable media attention has focused on the inappropriate use of tax-exempt insurance companies to shelter investment income.[266] The Committee believes that the use of these organizations as vehicles for sheltering income was never contemplated by Congress. The proliferation of these organizations as a means to avoid tax on income, sometimes on large investment portfolios, is inconsistent with the original narrow scope of the provision, which has been in the tax law for decades. The Committee believes it is necessary to limit the availability of tax-exempt status under the provision so that it cannot be abused as a tax shelter. To that end, the bill applies a gross receipts test and requires that premiums received for the taxable year be greater than 50 percent of gross receipts.

The bill correspondingly expands the availability of the present-law election of a property and casualty insurer to be taxed only on taxable investment income to companies with premiums below $350,000. This provision of present law provides a relatively simple tax calculation for small property and casualty insurers, and because the election results in the taxation of investment income, the Committee does not believe that it is abused to avoid tax on investment income. Thus, the bill provides that a company whose net written premiums (or if greater, direct written premiums) do not exceed $1.2 million (without regard to the $350,000 threshhold of present law) is eligible for the simplification benefit of this election.

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[266] See David Cay Johnston, *Insurance Loophole Helps Rich,* N.Y. Times, April 1, 2003; David Cay Johnston, *Tiny Insurers Face Scrutiny as Tax Shields,* N.Y. Times, April 4, 2003, at C1; Janet Novack, *Are You a Chump?,* Forbes, Mar. 5, 2001

Explanation of Provision

The provision 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 provision, 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 provision expands the present-law controlled group rule so that it also takes into account gross receipts of foreign and tax-exempt corporations.

The provision 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) (sec. 831(b)). The provision 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.

No inference is intended that any company that is not an insurance company (i.e., a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies) can be eligible for tax-exempt status under present-law section 501(c)(15), or under the provision. It is intended that IRS enforcement activities address the misuse of present-law section 501(c)(15).

Further, it is not intended that the provision permitting a property and casualty insurance company to elect to be taxed only on taxable investment income become an area of abuse. While the bill retains the eligibility test based on premiums (rather than gross receipts), it is intended that regulations or other Treasury guidance provide for anti-abuse rules to so as to prevent improper use of the provision, including by characterizing as premiums income that is other than premium income.

Effective Date

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

J. Authorize IRS to Enter into Installment Agreements that Provide for Partial Payment (sec. 360 of the bill and sec. 6159 of the Code)

Present Law

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

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

Reasons for Change

The Committee believes that clarifying 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 will improve effective tax administration.

The Committee recognizes that some taxpayers are unable or unwilling to enter into a realistic offer in compromise. The Committee believes that these taxpayers should be encouraged to make partial payments toward resolving their tax liability, and that providing for partial payment installment agreements will help facilitate this. The Committee also believes, however, that the offer in compromise program should remain the sole avenue via which taxpayers fully resolve their tax liabilities and attain a fresh start.

Explanation of Provision

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

Effective Date

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

K. Extend the Present-Law Intangible Amortization Provisions to Acquisitions of Sports Franchises (sec. 361 of the bill and sec. 197 of the Code)

Present Law

The purchase price allocated to intangible assets (including franchise rights) acquired in connection with the acquisition of a trade or business generally must be capitalized and amortized over a 15-year period.[267] These rules were enacted in 1993 to minimize disputes regarding the proper treatment of acquired intangible assets. The rules do not apply to a franchise to engage in professional sports and any intangible asset acquired in connection with such a franchise.[268] However, other special rules apply to certain of these intangible assets.

Under section 1056, when a franchise to conduct a sports enterprise is sold or exchanged, the basis of a player contract acquired as part of the transaction is generally limited to the adjusted basis of such contract in the hands of the transferor, increased by the amount of gain, if any, recognized by the transferor on the transfer of the contract. Moreover, not more than 50 percent of the consideration from the transaction may be allocated to player contracts unless the transferee establishes to the satisfaction of the Commissioner that a specific allocation in excess of 50 percent is proper. However, these basis rules may not apply if a sale or exchange of a franchise to conduct a sports enterprise is effected through a partnership.[269] Basis allocated to the franchise or to other valuable intangible assets acquired with the franchise may not be amortizable if these assets lack a determinable useful life.

Reasons for Change

The present-law rules under section 197 were enacted to minimize disputes regarding the measurement of acquired intangible assets. Prior to the enactment of the rules, there were many disputes regarding the value and useful life of various intangible assets acquired together in a business acquisition. Furthermore, in the absence of a showing of a reasonably determinable useful life, an asset could not be amortized. Taxpayers tended to identify and allocate large amounts of purchase price to assets said to have short useful lives, while the IRS would allocate a large amount of value to intangible value for which no determinable useful life could be shown (e.g., goodwill), and would deny amortization for that amount of purchase price.

The present-law rules for acquisitions of sports franchises do not eliminate the potential for disputes, because they address only player contracts, while a sports franchise acquisition can involve many intangibles other than player contracts. In addition, disputes may arise regarding the appropriate period for amortization of particular player contracts. The Committee believes expending taxpayer and government resources disputing these items is an unproductive use of

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[267] Sec. 197.

[268] Sec. 197(e)(6).

[269] P.D.B. Sports, Ltd. v. Comm., 109 T.C. 423 (1997).

economic resources. The Committee further believes that the section 197 rules should apply to all types of businesses regardless of the nature of their assets.

Explanation of Provision

The provision extends the 15-year recovery period for intangible assets to franchises to engage in professional sports and any intangible asset acquired in connection with such a franchise acquisitions of sports franchises (including player contracts). Thus, the same rules for amortization of intangibles that apply to other acquisitions under present law will apply to acquisitions of sports franchises.

Effective Date

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

L. Deposits Made to Suspend the Running of Interest on Potential Underpayments (sec. 362 of the bill and new sec. 6603 of the Code)

Present Law

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

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

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

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

A deposit in the nature of a cash bond will stop the running of interest on an amount of underpayment equal to the deposit, but the deposit does not itself earn interest. A deposit in the nature of a cash bond is not a payment of tax and is not subject to a claim for credit or refund. A deposit in the nature of a cash bond may be made for all or part of the disputed liability and generally may be recovered by the taxpayer prior to a final determination. However, a deposit in the nature of a cash bond need not be refunded to the extent the Secretary determines that the assessment or collection of the tax determined would be in jeopardy, or that the deposit should be applied against another liability of the taxpayer in the same manner as an overpayment of tax. If the taxpayer 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.

Reasons for Change

The Committee believes that an improved deposit system that allows for the payment of interest on amounts that are not ultimately needed to offset tax liability when the taxpayer's position is upheld, as well as allowing for the offset of tax liability when the taxpayer's position fails, will provide an effective way for taxpayers to manage their exposure to underpayment interest. However, the Committee believes that such an improved deposit system should be reserved for the issues that are known to both parties, either through IRS examination or voluntary taxpayer disclosure.

Explanation of Provision

In general

The bill 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 provision applies to deposits made after the date of enactment. Amounts already on deposit as of the date of enactment are treated as deposited (for purposes of applying this provision) on the date the taxpayer identifies the amount as a deposit made pursuant to this provision. The provision ceases to have effect on December 31, 2012.

M. Clarification of Rules for Payment of Estimated Tax for Certain Deemed Asset Sales (sec. 363 of the bill and sec. 338 of the Code)

Present Law

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

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

Section 338(h)(13) provides that, for purposes of section 6655 (relating to additions to tax for failure by a corporation to pay estimated income tax), tax attributable to a deemed asset sale under section 338(a)(1) shall not be taken into account.

Reasons for Change

The Committee is concerned that some taxpayers may be taking the position that the section 338(h)(13) 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.

Typically, because the section 338(h)(10) election is made jointly by the buyer and the seller, the parties know at the time of the transaction whether such election will be made, and thus the seller should pay estimated taxes accordingly.

Furthermore, even if the parties do not know whether the election will be made, an actual stock sale has occurred that should be included in estimated tax liability.

Explanation of Provision

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

Under the bill, 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 is 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 is recomputed based on the asset sale election.

No inference is intended as to present law.

Effective Date

The bill is effective for transactions that occur after the date of enactment of the proposal.

N. Limit Deduction for Charitable Contributions of Patents and Similar Property (sec. 364 of the bill and sec. 170 of the Code)

Present Law

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization.[270] 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.

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[270] Charitable deductions are provided for income, estate, and gift tax purposes. Secs. 170, 2055, and 2522, respectively.

Reasons for Change

The Committee believes that in the context of charitable contributions the valuation of patents, copyrights, trademarks, trade names, trade secrets, know-how, software, similar property, or applications or registrations of such property is highly speculative. In theory, such intellectual property may promise significant monetary benefits, but the benefits will not materialize if the charity does not make the appropriate investments, have the right personnel and equipment, or even have sufficient sustained interest to exploit the intellectual property. In addition, some donated intellectual property may prove to be worthless, or the initial promise of worth may be diminished by future inventions and marketplace competition. The Committee understands that valuation is made yet more difficult in the charitable contribution context because the transferee does not provide full, if any, consideration in exchange for the transferred property pursuant to arm's length negotiations.

The Committee is concerned that taxpayers with patents or similar property are taking advantage of the inherent difficulties in valuing such property and are preparing or obtaining erroneous valuations. In such cases, the charity receives an asset of questionable value, while the company receives a significant tax benefit. The Committee believes that the excessive charitable contribution deductions enabled by inflated valuations is best addressed by ensuring that the amount of the deduction for charitable contributions of such property may not exceed the taxpayer's basis in the property. The Committee notes that for other types of charitable contributions for which valuation is especially problematic -- charitable contributions of property created by the personal efforts of the taxpayer and charitable contributions to certain private foundations -- a basis deduction generally is the result under present law.

Explanation of Provision

The provision provides that the amount of the deduction for charitable contributions of patents, copyrights, trademarks, trade names, trade secrets, know-how, software, similar property, or applications or registrations of such property may not exceed the taxpayer's basis in the contributed property.

The provision provides the Secretary of the Treasury with the authority to issue regulations or other guidance to prevent avoidance of the purposes of the provision. In general, the provision is intended to prevent taxpayers from claiming a deduction in excess of basis with respect to charitable contributions of patents or similar property. A taxpayer would contravene the purposes of the provision, for example, by engaging in transactions or other activity that manipulated the basis of the contributed property or changed the form of the contributed property in order to increase the amount of the deduction. This might occur, for instance, if a taxpayer, for the purpose of claiming a larger deduction, engaged in activity that increased the basis of the contributed property by using related parties, pass-thru entities, or other intermediaries or means. The purpose of the provision also would be abused if a taxpayer changed the form of the property by, for example, embedding the property into a product, contributing the product, and claiming a fair market value deduction based in part on the fair market value of the embedded property. In such a case, any guidance issued by the Secretary of the Treasury may provide that the taxpayer is required to separate the embedded property from the related product and treat the charitable contribution as contributions of distinct properties, with each property subject to the applicable deduction rules.

Effective Date

The provision is effective for contributions made after May 7, 2003.

O. Extension of Provision Permitting Qualified Transfers of Excess Pension Assets to Retiree Health Accounts (sec. 365 of the bill and sec. 420 of the Code, and secs. 101, 403, and 408 of ERISA)

Present Law

Defined benefit plan assets generally may not revert to an employer prior to termination of the plan and satisfaction of all plan liabilities. In addition, a reversion may occur only if the plan so provides. A reversion prior to plan termination may constitute a prohibited transaction and may result in plan disqualification. Any assets that revert to the employer upon plan termination are includible in the gross income of the employer and subject to an excise tax. The excise tax rate is 20 percent if the employer maintains a replacement plan or makes certain benefit increases in connection with the termination; if not, the excise tax rate is 50 percent. Upon plan termination, the accrued benefits of all plan participants are required to be 100-percent vested.

A pension plan may provide medical benefits to retired employees through a separate account that is part of such plan. A qualified transfer of excess assets of a defined benefit plan to such a separate account within the plan may be made in order to fund retiree health benefits.[271] A qualified transfer does not result in plan disqualification, is not a prohibited transaction, and is not treated as a reversion. Thus, transferred assets are not includible in the gross income of the employer and are not subject to the excise tax on reversions. No more than one qualified transfer may be made in any taxable year.

Excess assets generally means the excess, if any, of the value of the plan's assets[272] over the greater of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 170 percent of the plan's current liability (for 2003),[273] or (2) 125 percent of the plan's current liability. In addition, excess assets transferred in a qualified transfer may not exceed the amount reasonably estimated to be the amount that the employer will pay out of such account during the taxable year of the transfer for qualified current retiree health liabilities. No deduction

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[271] Sec. 420.

[272] The value of plan assets for this purpose is the lesser of fair market value or actuarial value.

[273] These amounts represent relate to the full funding limit for defined benefit plans. The current liability full funding limit is repealed for years beginning after 2003. Under the general sunset provision of EGTRRA, the limit is reinstated for years after 2010.

is allowed to the employer for (1) a qualified transfer or (2) the payment of qualified current retiree health liabilities out of transferred funds (and any income thereon).

Transferred assets (and any income thereon) must be used to pay qualified current retiree health liabilities for the taxable year of the transfer. Transferred amounts generally must benefit pension plan participants, other than key employees, who are entitled upon retirement to receive retiree medical benefits through the separate account. Retiree health benefits of key employees may not be paid out of transferred assets.

Amounts not used to pay qualified current retiree health liabilities for the taxable year of the transfer are to be returned to the general assets of the plan. These amounts are not includible in the gross income of the employer, but are treated as an employer reversion and are subject to a 20-percent excise tax.

In order for the transfer to be qualified, accrued retirement benefits under the pension plan generally must be 100-percent vested as if the plan terminated immediately before the transfer (or in the case of a participant who separated in the one-year period ending on the date of the transfer, immediately before the separation).

In order to a transfer to be qualified, the employer generally must maintain retiree health benefits at the same level for the taxable year of the transfer and the following four years.

In addition, the Employee Retirement Income Security Act of 1974 ("ERISA") provides that, at least 60 days before the date of a qualified transfer, the employer must notify the Secretary of Labor, the Secretary of the Treasury, employee representatives, and the plan administrator of the transfer, and the plan administrator must notify each plan participant and beneficiary of the transfer.[274]

No qualified transfer may be made after December 31, 2005.

Reasons for Change

The Committee believes it is appropriate to extend the ability of employers to fund retiree health benefits through the transfer of excess pension assets.

Explanation of Provision

The provision allows qualified transfers of excess defined benefit plan assets through December 31, 2013.

Effective Date

The provision is effective for transfers made in taxable years beginning after December 31, 2005.

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[274] ERISA sec. 101(e). ERISA also provides that a qualified transfer is not a prohibited transaction under ERISA or a prohibited reversion.

P. Proration Rules for Life Insurance Business of Property and Casualty Insurance Companies (sec. 366 of the bill and sec. 832(b)(4) of the Code)

Present Law

Life insurance company proration rules

A life insurance company is subject to tax on its life insurance company taxable income (LICTI) (sec. 801). LICTI is life insurance gross income reduced by life insurance deductions. For this purpose, a life insurance company includes in gross income any net decrease in reserves, and deducts a net increase in reserves. Because deductible reserve increases might be viewed as being funded proportionately out of taxable and tax-exempt income, the net increase and net decrease in reserves are computed by reducing the ending balance of the reserve items by the policyholders' share of tax-exempt interest (secs. 807(b)(2)(B) and (b)(1)(B)). Similarly, a life insurance company is allowed a dividends-received deduction for intercorporate dividends from nonaffiliates only in proportion to the company's share of such dividends (secs. 805(a)(4), 812). Fully deductible dividends from affiliates are excluded from the application of this proration formula, if such dividends are not themselves distributions from tax-exempt interest or from dividend income that would not be fully deductible if received directly by the taxpayer. In addition, the proration rule includes in prorated amounts the increase for the taxable year in policy cash values of life insurance policies and annuity and endowment contracts.

Property and casualty insurance company proration rules

The taxable income of a property and casualty insurance company is determined as the sum of its underwriting income and investment income (as well as gains and other income items), reduced by allowable deductions (sec. 832). Underwriting income means premiums earned during the taxable year less losses incurred and expenses incurred. In calculating its reserve for losses incurred, a property and casualty insurance company must reduce the amount of losses incurred by 15 percent of (1) the insurer's tax-exempt interest, (2) the deductible portion of dividends received (with special rules for dividends from affiliates), and (3) the increase for the taxable year in the cash value of life insurance, endowment or annuity contract (sec. 832(b)(5)(B)).

This 15-percent proration requirement was enacted in 1986. The reason the provision was adopted was Congress' belief that "it is not appropriate to fund loss reserves on a fully deductible basis out of income which may be, in whole or in part, exempt from tax. The amount of the reserves that is deductible should be reduced by a portion of such tax-exempt income to reflect the fact that reserves are generally funded in part from tax-exempt interest or from wholly or partially deductible dividends."[275]

[275] H. R. Rep. No. 99-426, Report of the Committee on Ways and Means on H.R. 3838, The Tax Reform Act of 1985 (99th Cong., 1st Sess.,), 670.

Property and casualty insurance companies with life insurance reserves

Present law provides that a life insurance company means an insurance company engaged in the business of issuing life insurance, annuity, or noncancellable accident and health insurance, provided its reserves meet a 50-percent threshhold for its reserves (sec. 816). More than 50 percent of its reserves must constitute life insurance reserves or reserves for noncancellable accident and health policies. An insurance company that does not meet this 50-percent threshhold for reserves generally is subject to tax as a property and casualty insurance company. In determining the amount of premiums earned for purposes of calculating its taxable income, a property and casualty insurance company includes in unearned premiums the amount of life insurance reserves determined under the rules applicable to life insurance companies (secs. 832(b)(4), 807).

Reasons for Change

The Committee is concerned that insurance companies have a tax-based incentive to be or become property and casualty insurers, rather than life insurers, because of the disparity in treatment under the proration rules of life insurance reserves of the two types of companies. The Committee believes that this incentive is unintentional and should be corrected so that the rules are neutral as to the tax treatment under the proration rules of the type of business giving rise to life reserves, whether the company is a life company or a property and casualty company. The Committee believes that the appropriate proration rules for this type of business are the life insurance proration rules, not only because these reserves reflect life insurance business, but also because the life insurance proration rules reflect more accurately than do the property and casualty percentage proration rule the portion of deductible expenses that would otherwise be paid out of untaxed income. Thus, the Committee bill applies the life insurance company proration rules with respect to the business giving rise to life insurance reserves of property and casualty insurance companies.

Explanation of Provision

The provision provides that the life insurance company proration rules, rather than the property and casualty insurance proration rules, apply with respect to life insurance reserves of a property and casualty company.

Specifically, the provision provides that any deduction attributable to life insurance reserves included in unearned premiums of a property and casualty company under section 832(b)(4) is reduced in the same manner as dividends received deductions of a life insurance company are reduced under the proration rules of section 805(a)(4).[276] In applying the policyholder's share and the company's share under this reduction, section 812 applies with respect to the life insurance business of the property and casualty company. For this purpose, under section 812(d), only the gross investment income attributable to the life insurance reserves

[276] As under present law, the reserve deduction determined under section 807 for life insurance reserves included in unearned premiums is reduced by the policyholder's share of tax-exempt interest and of the increase in policy cash values (sec. 807(a)(2)(B) and (b)(1)(B)).

referred to in section 832(b)(4) are taken into account. It is expected that Treasury will provide guidance as to reasonable methods of attributing gross investment income to such life insurance reserves.

Effective Date

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

Q. Modify Treatment of Transfers to Creditors in Divisive Reorganizations (sec. 367 of the bill and secs. 357(c) and 361 of the Code)

Present Law

Section 355 of the Code permits a corporation ("distributing") to separate its businesses by distributing a subsidiary tax-free, if certain conditions are met. In cases where the distributing corporation contributes property to the corporation ("controlled') that is to be distributed, no gain or loss is recognized if the property is contributed solely in exchange for stock or securities of the controlled corporation (which are subsequently distributed to distributing's shareholders). The contribution of property to a controlled corporation that is followed by a distribution of its stock and securities may qualify as a reorganization described in section 368(a)(1)(D). That section also applies to certain transactions that do not involve a distribution under section 355 and that are considered 'acquisitive" rather than "divisive" reorganizations.

The contribution in the course of a divisive section 368(a)(1)(D) reorganization is also subject to the rules of section 357(c). That section provides that the transferor corporation will recognize gain if the amount of liabilities assumed by controlled exceeds the basis of the property transferred to it.

Because the contribution transaction in connection with a section 355 distribution is a reorganization under section 368(a)(1)(D), it is also subject to certain rules applicable to both divisive and acquisitive reorganizations. One such rule, in section 361(b), states that a transferor corporation will not recognize gain if it receives money or other property and distributes that money or other property to its shareholders or creditors. The amount of property that may be distributed to creditors without gain recognition is unlimited under this provision.

Reasons for Change

The Committee is concerned that taxpayers engaged in a divisive section 355 transaction can effectively avoid the rules that require gain recognition if the controlled corporation assumes liabilities of the transferor that exceed the basis of assets transferred to such corporation. This could occur because of the rules of section 361(b), which state that the transferor can receive money or other property from the transferee without gain recognition, so long as that money or property is distributed to creditors of the transferor. For example, a transferor corporation could receive money from the transferee corporation (e.g. money obtained from a borrowing by the transferee) and use that money to pay the transferor's creditors, without gain recognition. The transaction is economically similar to the actual assumption by the transferee of the transferor's liabilities, but is taxed differently because section 361(b) does not contain a limitation on the amount that can be distributed to creditors.

The Committee also believes it is appropriate to permit the transferor to assume liabilities of the transferee without application of the rules of section 357(c) in an acquisitive reorganization under section 368(a)(1)(D). In such an acquisitive reorganization, the transferor must generally transfer substantially all its assets to the acquiring corporation, and then go out of existence. Assumption of its liabilities by the acquiring corporation thus does not enrich the transferor corporation, which ceases to exist and whose liability was limited to its assets in any event by its corporate form. The Committee believes that the treatment of such acquisitive reorganizations should be conformed to that of other acquisitive reorganizations.

Explanation of Provision

The bill limits the amount of money or other property that a distributing corporation can distribute to its creditors without gain recognition under section 361(b) to the amount of the basis of the assets contributed to a controlled corporation in a divisive reorganization. In addition, the bill provides that acquisitive reorganizations under section 368(a)(1)(D) are no longer subject to the liabilities assumption rules of section 357(c).

Effective Date

The bill is effective for transactions on or after the date of enactment.

SUBTITLE F – OTHER PROVISIONS

A. Temporary State Fiscal Relief Fund (sec. 371 of the bill)

Present Law

No provision.

Reasons for Change

Since the start of the latest recession, State governments have seen a significant decline in revenue growth. As a result of this and other factors, many States are now facing the prospect of sizable budget deficits. However, nearly every State has some type of balanced budget requirement with respect to its general fund. Therefore, many States are laying off workers, reducing spending, or raising taxes. The Committee believes that the Federal government could potentially mitigate the impact of these actions by providing some form of temporary relief to the States. Such relief could be provided through a number of mechanisms: including grants to States, changes in Medicaid, and a reduction or elimination of unfunded mandates.

Explanation of Provision

The provision establishes a temporary fund to provide $20 billion, divided among State and local governments, to be used for health care, education or job training; transportation or infrastructure; law enforcement or public safety; and other essential governmental services. In addition, a portion of the total amount shall be transferred to States under Title XIX of the Social Security Act.

Effective Date

The provision is effective on the date of enactment.

B. SSI Redetermination (sec. 372 of the bill)

Present Law

State agencies are required to conduct blindness and disability determinations to establish an individual's eligibility for: (1) Title II (Federal Old-Age, Survivors, and Disability Insurance (OASDI) benefits); and (2) Title XVI (Supplemental Security Income (SSI)). Disability determinations are made in accordance with disability criteria defined in statute as well as standards promulgated under regulations or other guidance.

Under present law, the Commissioner of Social Security is required to review the State agencies' Title II initial blindness and disability determinations in advance of awarding payment to individuals determined eligible. This requirement for review is met when: (1) at least 50 percent of all such determinations have been reviewed, or (2) other such determinations have been reviewed as necessary to ensure a high level of accuracy. Under present law, there is no similar review for Title XVI.

Reasons for Change

The Committee believes that the provision will improve the accuracy of eligibility determinations in the SSI program and reduce the number of ineligible individuals receiving benefits.

Explanation of Provision

The bill aligns initial review requirements for Title XVI with those currently required under Title II. As under Title II, the Commissioner of Social Security is required to review initial Title XVI SSI blindness and disability determinations made by State agencies in advance of awarding payments. In fiscal year 2004, the SSI review is required for 25 percent of all State-determined allowances. In fiscal year 2005 and thereafter, review is required for at least 50 percent of State-determined allowances. To the extent feasible, the bill requires the Commissioner to select for review those State agency determinations that are most likely to be incorrect.

Effective Date

The provision is effective on October 1, 2003.

C. Covering Childless Adults with SCHIP Funds (sec. 373 of the bill)

Present Law

Title XXI of the Social Security Act provides states with allocations to provide health insurance for children through State Children Health Insurance Program (SCHIP). In this statute, Congress specified that SCHIP allocations could only 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."[277]

Reasons for Change

The Committee believes that the use of funds dedicated by Congress to low-income uninsured children on childless adults is an inappropriate implementation of the SCHIP statute.

Explanation of Provision

In the past, the Secretary of HHS has approved waivers that spend SCHIP dollars to cover childless adults. The provision clarifies the intent of Congress specifically stating that SCHIP funds cannot be spent on childless adults. Further, the provision clarifies that it is illegal

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[277] Social Security Act section 2101(a).

for the Secretary to approve a waiver providing health insurance coverage through SCHIP to childless adults. The provision does not affect the ability of the Secretary to award an SCHIP waiver for the coverage of pregnant women.

Effective Date

The provision is effective on the date of enactment.

TITLE IV – SMALL BUSINESS AND AGRICULTURAL PROVISIONS

A. Exclusion of Certain Indebtedness of Small Business Investment Companies From Acquisition Indebtedness (sec. 401 of the bill and sec. 514 of the Code)

Present Law

In general, an organization that is otherwise exempt from Federal income tax is taxed on income from a trade or business that is unrelated to the organization's exempt purposes. Certain types of income, such as rents, royalties, dividends, and interest, generally are excluded from unrelated business taxable income except when such income is derived from "debt-financed property." Debt-financed property generally means any property that is held to produce income and with respect to which there is acquisition indebtedness at any time during the taxable year.

In general, income of a tax-exempt organization that is produced by debt-financed property is treated as unrelated business income in proportion to the acquisition indebtedness on the income-producing property. Acquisition indebtedness generally means the amount of unpaid indebtedness incurred by an organization to acquire or improve the property and indebtedness that would not have been incurred but for the acquisition or improvement of the property.[278] Acquisition indebtedness does not include, however, (1) certain indebtedness incurred in the performance or exercise of a purpose or function constituting the basis of the organization's exemption, (2) obligations to pay certain types of annuities, (3) an obligation, to the extent it is insured by the Federal Housing Administration, to finance the purchase, rehabilitation, or construction of housing for low and moderate income persons, or (4) indebtedness incurred by certain qualified organizations to acquire or improve real property. An extension, renewal, or refinancing of an obligation evidencing a pre-existing indebtedness is not treated as the creation of a new indebtedness.

Reasons for Change

The Committee believes that subjecting a tax-exempt organization to unrelated business income tax in cases where a small business investment company is required by Federal law to issue debt inappropriately discourages investment by tax-exempt organizations in small business investment companies. The Committee believes that the provision will stimulate investment by tax-exempt organizations in small business investment companies and increase the flow of venture capital to small businesses.

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[278] Special rules apply in the case of an exempt organization that owns a partnership interest in a partnership that holds debt-financed income-producing property. An exempt organization's share of partnership income that is derived from such debt-financed property generally is taxed as debt-financed income unless an exception provides otherwise.

Explanation of Provision

The provision modifies the debt-financed property provisions by excluding from the definition of acquisition indebtedness any indebtedness incurred by a small business investment company licensed under the Small Business Investment Act of 1958 that is evidenced by a debenture (1) issued by such company under section 303(a) of said Act, or (2) held or guaranteed by the Small Business Administration.

Effective Date

The provision applies to debt incurred by a small business investment company described in the provision after December 31, 2002, with respect to property it acquires after such date.

B. Repeal Special Occupational Taxes on Producers and Marketers of Alcoholic Beverages (sec. 402 of the bill and secs. 5081, 5091, 5111, 5121, 5131, and 5276 of the Code)

Present Law

Under present law, special occupational taxes are imposed on producers and others engaged in the marketing of distilled spirits, wine, and beer. These excise taxes are imposed as part of a broader Federal tax and regulatory engine governing the production and marketing of alcoholic beverages. The special occupational taxes are payable annually, on July 1 of each year. The present tax rates are as follows:

Producers[279]:	
Distilled spirits and wines (sec. 5081)	$1,000 per year, per premise
Brewers (sec. 5091)	$1,000 per year, per premise
Wholesale dealers (sec. 5111):	
Liquors, wines, or beer	$500 per year
Retail dealers (sec. 5121):	
Liquors, wines, or beer	$250 per year
Nonbeverage use of distilled spirits (sec. 5131):	$500 per year
Industrial use of distilled spirits (sec. 5276):	$250 per year

Reasons for Change

The special occupational tax is not a tax on alcoholic products but rather operates as a license fee on businesses. The Committee believes that this is an inequitable tax that has

[279] A reduced rate of tax in the amount of $500.00 is imposed on small proprietors (as defined in the Code) (secs. 5081(b) and 5091(b)).

outlived its original purpose and places an unfair burden on small business owners. According to the Treasury Department, there are almost a half million retailers that pay the annual $250 special occupational tax. Repeal of this tax will provide relief to thousands of small business owners. The Committee notes that the staff of the Joint Committee on Taxation has previously recommended, as a simplification measure, that the special occupational tax be repealed.[280]

Explanation of Provision

The special occupational taxes on producers and marketers of alcoholic beverages are repealed. The recordkeeping and inspection authorities applicable to wholesalers and retailers are retained. For purposes of the recordkeeping requirements for wholesale and retail liquor dealers, the provision provides a rebuttable presumption that a person who sells, or offers for sale, distilled spirits, wine, or beer, in quantities of 20 wine gallons or more to the same person at the same time is engaged in the business of a wholesale dealer in liquors or a wholesale dealer in beer. In addition, the provision retains present-law in that continues to make it unlawful for any liquor dealer to purchase distilled spirits for resale from any person other than a wholesale liquor dealer subject to the recordkeeping requirements. Existing general criminal penalties relating to records and reports apply to wholesalers and retailers who fail to comply with these requirements.

Effective Date

The provision is effective on July 1, 2003. The provision does not affect liability for taxes imposed with respect to periods before July 1, 2003.

C. Custom Gunsmiths (sec. 403 of the bill and sec. 4182 of the Code)

Present Law

The Code imposes an excise tax upon the sale by the manufacturer, producer or importer of certain firearms and ammunition (sec. 4181). Pistols and revolvers are taxable at 10 percent. Firearms (other than pistols and revolvers), shells, and cartridges are taxable at 11 percent. The excise tax for firearms imposed on manufacturers, producers, and importers does not apply to machine guns and short barreled firearms. Sales to the Defense Department of firearms, pistols, revolvers, shells and cartridges also are exempt from the tax (sec. 4182).

Reasons for Change

Many custom gunsmiths do not actually make new guns, rather they remodel or refurbish existing firearms. The provision establishes an exemption from the excise tax for manufacturers of fewer than 50 firearms per year. The Committee believes two worthy objectives are accomplished under the provision. First, this provision eliminates the assessment of the excise

[280] Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986 (JCS-3-01)*, April 2001 at 512.

tax on custom gunmakers, and second, it eliminates the significant administrative burden placed on small businesses, such as determining the manufacturer and the person to assess and collect the tax.

Explanation of Provision

The provision exempts from the firearms excise tax articles manufactured, produced, or imported by a person who manufactures, produces, and imports less than 50 of such articles during the calendar year. Controlled groups are treated as a single person for determining the 50-article limit.

Effective Date

The provision is effective for articles sold by the manufacturer, producer, or importer on or before the date the first day of the month beginning at least two weeks after the date of enactment. No inference is intended from the prospective effective date of this provision as to the proper treatment of pre-effective date sales.

D. Simplification of Excise Tax Imposed on Bows and Arrows (sec. 404 of the bill and sec. 4161 of the Code)

Present Law

The Code imposes an excise tax of 11 percent on the sale by a manufacturer, producer or importer of any bow with a draw rate of 10 pounds or more (sec. 4161(b)(1)(A)). An excise tax of 12.4 percent is imposed on the sale by a manufacturer or importer of any shaft, point, nock, or vane designed for use as part of an arrow which after its assembly (1) is over 18 inches long, or (2) is designed for use with a taxable bow (if shorter than 18 inches) (sec. 4161(b)(2)). No tax is imposed on finished arrows. An 11-percent excise tax also is imposed on any part of an accessory for taxable bows and on quivers for use with arrows (1) over 18 inches long or (2) designed for use with a taxable bow (if shorter than 18 inches) (sec. 4161(b)(1)(B)).

Reasons for Change

Under present law, foreign manufacturers and importers of arrows avoid the 12.4 percent excise tax paid by domestic manufacturers because the tax is placed on arrow components rather than finished arrows. As a result, arrows assembled outside of the United States have a price advantage over domestically manufactured arrows. The Committee believes it is appropriate to close this loophole. The Committee also believes that adjusting the minimum draw weight for a taxable for taxable bows from ten pounds to 30 pounds will better target the excise tax to actual hunting use by eliminating the excise tax on instructional ("youth") bows.

Explanation of Provision

The provision increases the minimum draw weight for a taxable bow from 10 pounds to 30 pounds. The provision also imposes an excise tax of 12 percent on arrows generally. An arrow for this purpose would be defined as an arrow shaft to which additional components are attached. The present law 12.4-percent excise tax on certain arrow components is unchanged by the proposal. The provision provides that the 12-percent excise tax on arrows would not apply if the arrow contains an arrow shaft that was subject to the tax on arrow components. Finally, the provision subjects certain broadheads (a type of arrow point) to an excise tax equal to 11 percent of the sales price instead of 12.4 percent.

Effective Date

The provision is effective on the date of enactment for articles sold by the manufacturer, producer, or importer.

E. Capital Gains Treatment to Apply to Outright Sales of Timber by Landowner (sec. 411 of the bill and sec. 631(b) of the Code)

Present Law

Under present law, a taxpayer disposing of timber held for more than one year is eligible for capital gains treatment in three situations. First, if the taxpayer sells or exchanges timber that is a capital asset (sec. 1221) or property used in the trade or business (sec. 1231), the gain generally is long-term capital gain; however, if the timber is held for sale to customers in the taxpayer's business, the gain will be ordinary income. Second, if the taxpayer disposes of the timber with a retained economic interest, the gain is eligible for capital gain treatment (sec. 631(b)). Third, if the taxpayer cuts standing timber, the taxpayer may elect to treat the cutting as a sale or exchange eligible for capital gains treatment (sec. 631(a)).

Reasons for Change

The Committee believes that the requirement that the owner of timber retain an economic interest in the timber in order to obtain capital gain treatment under section 631(b) results in poor timber management because the buyer, when cutting and removing timber, has no incentive to protect young or other uncut trees because the buyer only pays for the timber that is cut and removed. Therefore, the Committee bill eliminates this requirement and provides for capital gain treatment under section 631(b) in the case of outright sales of timber.

Explanation of Provision

Under the provision, in the case of a sale of timber by the owner of the land from which the timber is cut, the requirement that a taxpayer retain an economic interest in the timber in order to treat gains as capital gain under section 631(b) does not apply. Outright sales of timber by the landowner will qualify for capital gains treatment in the same manner as sales with a retained economic interest qualify under present law, except that the usual tax rules relating to the timing of the income from the sale of the timber will apply (rather than the special rule of section 631(b) treating the disposal as occurring on the date the timber is cut).

Effective Date

The provision is effective for sales of timber after the date of enactment.

F. Special Rules for Livestock Sold on Account of Weather-Related Conditions (sec. 412 of the bill and secs. 1033 and 451 of the Code)

Present Law

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

Under section 1033, gain realized by a taxpayer from an involuntary conversion of property is deferred to the extent the taxpayer purchases property similar or related in service or use to the converted property within the applicable period. The taxpayer's basis in the replacement property generally is the same as the taxpayer's basis in the converted property, decreased by the amount of any money or loss recognized on the conversion, and increased by the amount of any gain recognized on the conversion.

The applicable period for the taxpayer to replace the converted property begins with the date of the disposition of the converted property (or if earlier, the earliest date of the threat or imminence of requisition or condemnation of the converted property) and ends two years after the close of the first taxable year in which any part of the gain upon conversion is realized (the "replacement period"). Special rules extend the replacement period for certain real property and principal residences damaged by a Presidentially declared disaster to three years and four years, respectively, after the close of the first taxable year in which gain is realized.

Section 1033(e) provides that the sale of livestock (other than poultry) that is held for draft, breeding, or dairy purposes in excess of the number of livestock that would have been sold but for drought, flood, or other weather-related conditions is treated as an involuntary conversion. Consequently, gain from the sale of such livestock could be deferred by reinvesting the proceeds of the sale in similar property within a two-year period.

In general, cash-method taxpayers report income in the year it is actually or constructively received. However, section 451(e) provides that a cash-method taxpayer whose principal trade or business is farming who is forced to sell livestock due to drought, flood, or other weather-related conditions may elect to include income from the sale of the livestock in the taxable year following the taxable year of the sale. This elective deferral of income is available only if the taxpayer establishes that, under the taxpayer's usual business practices, the sale would not have occurred but for drought, flood, or weather-related conditions that resulted in the area being designated as eligible for Federal assistance. This exception is generally intended to put taxpayers who receive an unusually high amount of income in one year in the position they would have been in absent the weather-related condition.

Reasons for Change

The Committee is aware of situations in which cattlemen sold livestock in excess of the their usual business practice as a result of weather-related conditions, but have been unable to purchase replacement property because the weather-related conditions have continued. The

Committee believes it is appropriate to extend the time period for cattlemen to purchase replacement property in such situations.

Explanation of Provision

The provision extends the applicable period for a taxpayer to replace livestock sold on account of drought, flood, or other weather-related conditions from two years to four years after the close of the first taxable year in which any part of the gain on conversion is realized. The extension is only available if the taxpayer establishes that, under the taxpayer's usual business practices, the sale would not have occurred but for drought, flood, or weather-related conditions that resulted in the area being designated as eligible for Federal assistance. In addition, the Secretary of the Treasury is granted authority to further extend the replacement period on a regional basis should the weather-related conditions continue longer than three years. For property eligible for the provision's extended replacement period, the provision provides that the taxpayer can make an election under section 451(e) until the period for reinvestment of such property under section 1033 expires.

Effective Date

The provision is effective for any taxable year with respect to which the due date (without regard to extensions) for the return is after December 31, 2002.

G. Exclusion from Gross Income for Amounts Paid Under National Health Service Corps Loan Repayment Program (sec. 413 of the bill and sec. 108 of the Code)

Present Law

The National Health Service Corps Loan Repayment Program (the "NHSC Loan Repayment Program") provides loan repayments to participants on condition that the participants provide certain services. In the case of the NHSC Loan Repayment Program, the recipient of the loan repayment is obligated to provide medical services in a geographic area identified by the Public Health Service as having a shortage of health-care professionals. Loan repayments may be as much as $35,000 per year of service plus a tax assistance payment of 39 percent of the repayment amount.

Generally, gross income means all income from whatever source derived including income for the discharge of indebtedness. However, gross income does not include discharge of indebtedness income if: (1) the discharge occurs in a Title 11 case; (2) the discharge occurs when the taxpayer is insolvent; (3) the indebtedness discharged is qualified farm indebtedness; or (4) except in the case of a C corporation, the indebtedness discharged is qualified real property business indebtedness.

Because the loan repayments provided under the NHSC Loan Repayment Program are not specifically excluded from gross income, they are gross income to the recipient.

Reasons for Change

Elimination of the tax on loan repayments provided under the NHSC Loan Repayment Program will free up NHSC resources and improve their ability to attract medical professionals to underserved areas.

Explanation of Provision

The provision excludes from gross income loan repayments provided under the NHSC Loan Repayment Program.

Effective Date

The provision is effective with respect to amounts received in taxable years beginning after December 31, 2002.

H. Payment of Dividends on Stock of Cooperatives Without Reducing Patronage Dividends (sec. 414 of the bill and sec. 1388 of the Code)

Present Law

Under present law, cooperatives generally are entitled to deduct or exclude amounts distributed as patronage dividends in accordance with Subchapter T of the Code. In general, patronage dividends are comprised of amounts that are paid to patrons (1) on the basis of the quantity or value of business done with or for patrons, (2) under a valid and enforceable obligation to pay such amounts that was in existence before the cooperative received the amounts paid, and (3) which are determined by reference to the net earnings of the cooperative from business done with or for patrons.

Treasury Regulations provide that net earnings are reduced by dividends paid on capital stock or other proprietary capital interests (referred to as the "dividend allocation rule").[281] The dividend allocation rule has been interpreted to require that such dividends be allocated between a cooperative's patronage and nonpatronage operations, with the amount allocated to the patronage operations reducing the net earnings available for the payment of patronage dividends.

Reasons for Change

The Committee believes that the dividend allocation rule should not apply to the extent that the organizational documents of a cooperative provide that capital stock dividends do not reduce the amounts owed to patrons as patronage dividends. To the extent that capital stock dividends are in addition to amounts paid under the cooperative's organizational documents to patrons as patronage dividends, the Committee believes that those capital stock dividends are not being paid from earnings from patronage business.

[281] Treas. Reg. sec. 1.1388-1(a)(1).

In addition, the Committee believes cooperatives should be able to raise needed equity capital by issuing capital stock without dividends paid on such stock causing the cooperative to be taxed on a portion of its patronage income, and without preventing the cooperative from being treated as operating on a cooperative basis.

Explanation of Provision

The provision provides a special rule for dividends on capital stock of a cooperative. To the extent provided in organizational documents of the cooperative, dividends on capital stock do not reduce patronage income and do not prevent the cooperative from being treated as operating on a cooperative basis.

Effective Date

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

TITLE V – SIMPLIFICATION AND OTHER PROVISIONS

SUBTITLE A – SIMPLIFICATION

A. Establish Uniform Definition of a Qualifying Child (secs. 501-508 of the bill and secs. 2, 21, 24, 32, 151, and 152 of the Code)

Present Law

In general

Present law contains five commonly used provisions that provide benefits to taxpayers with children: (1) the dependency exemption; (2) the child credit; (3) the earned income credit; (4) the dependent care credit; and (5) head of household filing status. Each provision has separate criteria for determining whether the taxpayer qualifies for the applicable tax benefit with respect to a particular child. The separate criteria include factors such as the relationship (if any) the child must bear to the taxpayer, the age of the child, and whether the child must live with the taxpayer. Thus, a taxpayer is required to apply different definitions to the same individual when determining eligibility for these provisions, and an individual who qualifies a taxpayer for one provision does not automatically qualify the taxpayer for another provision.

Dependency exemption[282]

In general

Taxpayers are entitled to a personal exemption deduction for the taxpayer, his or her spouse, and each dependent. For 2003, the amount deductible for each personal exemption is $3,050. The deduction for personal exemptions is phased out for taxpayers with incomes above certain thresholds.[283]

In general, a taxpayer is entitled to a dependency exemption for an individual if the individual: (1) satisfies a relationship test or is a member of the taxpayer's household for the entire taxable year; (2) satisfies a support test; (3) satisfies a gross income test or is a child of the taxpayer under a certain age; (4) is a citizen or resident of the U.S. or resident of Canada or

[282] Secs. 151 and 152. Under the statutory structure, section 151 provides for the deduction for personal exemptions with respect to "dependents." The term "dependent" is defined in section 152. Most of the requirements regarding dependents are contained in section 152; section 151 contains additional requirements that must be satisfied in order to obtain a dependency exemption with respect to a dependent (as so defined). In particular, section 151 contains the gross income test, the rules relating to married dependents filing a joint return, and the requirement for a taxpayer identification number. The other rules discussed here are contained in section 151.

[283] Sec. 151(d)(3).

Mexico;[284] and (5) did not file a joint return with his or her spouse for the year.[285] In addition, the taxpayer identification number of the individual must be included on the taxpayer's return.

Relationship or member of household test

Relationship test.–The relationship test is satisfied if an individual is the taxpayer's (1) son or daughter or a descendant of either (e.g., grandchild or great-grandchild); (2) stepson or stepdaughter; (3) brother or sister (including half brother, half sister, stepbrother, or stepsister); (4) parent, grandparent, or other direct ancestor (but not foster parent); (5) stepfather or stepmother; (6) brother or sister of the taxpayer's father or mother; (7) son or daughter of the taxpayer's brother or sister; or (8) the taxpayer's father-in-law, mother-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law.

An adopted child (or a child who is a member of the taxpayer's household and who has been placed with the taxpayer for adoption) is treated as a child of the taxpayer. A foster child is treated as a child of the taxpayer if the foster child is a member of the taxpayer's household for the entire taxable year.

Member of household test.–If the relationship test is not satisfied, then the individual may be considered the dependent of the taxpayer if the individual is a member of the taxpayer's household for the entire year. Thus, a taxpayer may be eligible to claim a dependency exemption with respect to an unrelated child who lives with the taxpayer for the entire year.

For the member of household test to be satisfied, the taxpayer must both maintain the household and occupy the household with the individual.[286] A taxpayer or other individual does not fail to be considered a member of a household because of "temporary" absences due to special circumstances, including absences due to illness, education, business, vacation, and military service.[287] Similarly, an individual does not fail to be considered a member of the taxpayer's household due to a custody agreement under which the individual is absent for less than six months.[288] Indefinite absences that last for more than the taxable year may be considered "temporary." For example, the IRS has ruled that an elderly woman who was indefinitely confined to a nursing home was temporarily absent from a taxpayer's household.

[284] A legally adopted child who does not satisfy the residency or citizenship requirement may nevertheless qualify as a dependent (provided other applicable requirements are met) if (1) the child's principal place of abode is the taxpayer's home and (2) the taxpayer is a citizen or national of the United States. Sec. 152(b)(3).

[285] This restriction does not apply if the return was filed solely to obtain a refund and no tax liability would exist for either spouse if they filed separate returns. Rev. Rul. 54-567, 1954-2 C.B. 108.

[286] Treas. Reg. sec. 1.152-1(b).

[287] *Id.*

[288] *Id.*

Under the facts of the ruling, the woman had been an occupant of the household before being confined to a nursing home, the confinement had extended for several years, and it was possible that the woman would die before becoming well enough to return to the taxpayer's household. There was no intent on the part of the taxpayer or the woman to change her principal place of abode.[289]

Support test

In general.–The support test is satisfied if the taxpayer provides over one half of the support of the individual for the taxable year. To determine whether a taxpayer has provided more than one half of an individual's support, the amount the taxpayer contributed to the individual's support is compared with the entire amount of support the individual received from all sources, including the individual's own funds.[290] Governmental payments and subsidies (e.g., Temporary Assistance to Needy Families, food stamps, and housing) generally are treated as support provided by a third party. Expenses that are not directly related to any one member of a household, such as the cost of food for the household, must be divided among the members of the household. If any person furnishes support in kind (e.g., in the form of housing), then the fair market value of that support must be determined.

Multiple support agreements.–In some cases, no one taxpayer provides more than one half of the support of a individual. Instead, two or more taxpayers, each of whom would be able to claim a dependency exemption but for the support test, together provide more than one half of the individual's support. If this occurs, the taxpayers may agree to designate that one of the taxpayers who individually provides more than 10 percent of the individual's support can claim a dependency exemption for the child. Each of the others must sign a written statement agreeing not to claim the exemption for that year. The statements must be filed with the income tax return of the taxpayer who claims the exemption.

Special rules for divorced or legally separated parents.–Special rules apply in the case of a child of divorced or legally separated parents (or parents who live apart at all times during the last six months of the year) who provide over one half the child's support during the calendar year.[291] If such a child is in the custody of one or both of the parents for more than one half of the year, then the parent having custody for the greater portion of the year is deemed to satisfy the support test; however, the custodial parent may release the dependency exemption to the noncustodial parent by filing a written declaration with the IRS.[292]

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[289] Rev. Rul. 66-28, 1966-1 C.B. 31.

[290] In the case of a son, daughter, stepson, or stepdaughter of the taxpayer who is a full-time student, scholarships are not taken into account for purpose of the support test. Sec. 152(d).

[291] For purposes of this rule, a "child" means a son, daughter, stepson, or stepdaughter (including an adopted child or foster child, or child placed with the taxpayer for adoption). Sec. 152(e)(1)(A).

[292] Special support rules also apply in the case of certain pre-1985 agreements between divorced or legally separated parents. Sec. 152(e)(4).

Gross income test

In general, an individual may not be claimed as a dependent of a taxpayer if the individual has gross income that is at least equal to the personal exemption amount for the taxable year.[293] If the individual is the child of the taxpayer and under age 19 (or under age 24, if a full-time student), the gross income test does not apply.[294] For purposes of this rule, a "child" means a son, daughter, stepson, or stepdaughter (including an adopted child of the taxpayer, a foster child who resides with the taxpayer for the entire year, or a child placed with the taxpayer for adoption by an authorized adoption agency).

Earned income credit[295]

In general

In general, the earned income credit is a refundable credit for low-income workers. The amount of the credit depends on the earned income of the taxpayer and whether the taxpayer has one, more than one, or no "qualifying children." In order to be a qualifying child for the earned income credit, an individual must satisfy a relationship test, a residency test, and an age test. In addition, the name, age, and taxpayer identification number of the qualifying child must be included on the return.

Relationship test

An individual satisfies the relationship test under the earned income credit if the individual is the taxpayer's: (1) son, daughter, stepson, or stepdaughter, or a descendant of any such individual;[296] (2) brother, sister, stepbrother, or stepsister, or a descendant of any such individual, who the taxpayer cares for as the taxpayer's own child; or (3) eligible foster child. An eligible foster child is an individual (1) who is placed with the taxpayer by an authorized placement agency, and (2) who the taxpayer cares for as her or his own child. A married child of the taxpayer is not treated as meeting the relationship test unless the taxpayer is entitled to a dependency exemption with respect to the married child (e.g., the support test is satisfied) or would be entitled to the exemption if the taxpayer had not waived the exemption to the noncustodial parent.[297]

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[293] Certain income from sheltered workshops is not taken into account in determining the gross income of permanently and totally disabled individuals. Sec. 151(c)(5).

[294] Sec. 151(c).

[295] Sec. 32.

[296] A child who is legally adopted or placed with the taxpayer for adoption by an authorized adoption agency is treated as the taxpayer's own child. Sec. 32(c)(3)(B)(iv).

[297] Sec. 32(c)(3)(B)(ii).

Residency test

The residency test is satisfied if the individual has the same principal place of abode as the taxpayer for more than one half of the taxable year. The residence must be in the United States.[298] As under the dependency exemption (and head of household filing status), temporary absences due to special circumstances, including absences due to illness, education, business, vacation, and military service are not treated as absences for purposes of determining whether the residency test is satisfied.[299] Under the earned income credit, there is no requirement that the taxpayer maintain the household in which the taxpayer and the qualifying individual reside.

Age test

In general, the age test is satisfied if the individual has not attained age 19 as of the close of the calendar year. In the case of a full-time student, the age test is satisfied if the individual has not attained age 24 as of the close of the calendar year. In the case of an individual who is permanently and totally disabled, no age limit applies.

Child credit[300]

Taxpayers with incomes below certain amounts are eligible for a child credit for each qualifying child of the taxpayer. The amount of the child credit is up to $600, in the case of taxable years beginning in 2003 or 2004. The child credit increases to $700 for taxable years beginning in 2005 through 2008, $800 for taxable years beginning in 2009, and $1,000 for taxable years beginning in 2010. The credit declines to $500 in taxable year 2011.[301] For purposes of this credit, a qualifying child is an individual: (1) with respect to whom the taxpayer is entitled to a dependency exemption for the year; (2) who satisfies the same relationship test applicable to the earned income credit; and (3) who has not attained age 17 as of the close of the calendar year. In addition, the child must be a citizen or resident of the United States.[302] A portion of the child credit is refundable under certain circumstances.[303]

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[298] The principal place of abode of a member of the Armed Services is treated as in the United States during any period during which the individual is stationed outside the United States on active duty. Sec. 32(c)(4).

[299] IRS Publication 596, *Earned Income Credit (EIC)*, at 13. H. Rep. 101-964 (October 27, 1990), at 1037.

[300] Sec. 24.

[301] Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), Pub. L. No. 107-16, sec. 901(a) (2001) (making, by way of the EGTRRA sunset provision, the increase in the child credit inapplicable to taxable years beginning after December 31, 2010).

[302] The child credit does not apply with respect to a child who is a resident of Canada or Mexico and is not a U.S. citizen, even if a dependency exemption is available with respect to the child. Sec. 24(c)(2). The child credit is, however, available with respect to a child dependent who is not a resident or citizen of the United States if: (1) the child has been legally adopted by

Dependent care credit[304]

The dependent care credit may be claimed by a taxpayer who maintains a household that includes one or more qualifying individuals and who has employment-related expenses. A qualifying individual means (1) a dependent of the taxpayer under age 13 for whom the taxpayer is entitled to a dependency exemption, (2) a dependent of the taxpayer who is physically or mentally incapable of caring for himself or herself,[305] or (3) the spouse of the taxpayer, if the spouse is physically or mentally incapable of caring for himself or herself. In addition, a taxpayer identification number for the qualifying individual must be included on the return.

A taxpayer is considered to maintain a household for a period if over one half the cost of maintaining the household for the period is furnished by the taxpayer (or, if married, the taxpayer and his or her spouse). Costs of maintaining the household include expenses such as rent, mortgage interest (but not principal), real estate taxes, insurance on the home, repairs (but not home improvements), utilities, and food eaten in the home.

A special rule applies in the case of a child who is under age 13 or is physically or mentally incapable of caring for himself or herself if the custodial parent has waived his or her dependency exemption to the noncustodial parent.[306] For the dependent care credit, the child is treated as a qualifying individual with respect to the custodial parent, not the parent entitled to claim the dependency exemption.

Head of household filing status[307]

A taxpayer may claim head of household filing status if the taxpayer is unmarried (and not a surviving spouse) and pays more than one half of the cost of maintaining as his or her home a household which is the principal place of abode for more than one half of the year of (1) an unmarried son, daughter, stepson or stepdaughter of the taxpayer or an unmarried descendant of the taxpayer's son or daughter, (2) an individual described in (1) who is married, if the taxpayer may claim a dependency exemption with respect to the individual (or could claim the exemption

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the taxpayer; (2) the child's principal place of abode is the taxpayer's home; and (3) the taxpayer is a U.S. citizen or national. *See* sec. 24(c)(2) and sec. 152(b)(3).

[303] Sec. 24(d).

[304] Sec. 21.

[305] Although such an individual must be a dependent of the taxpayer as defined in section 152, it is not required that the taxpayer be entitled to a dependency exemption with respect to the individual under section 151. Thus, such an individual may be a qualifying individual for purposes of the dependent care credit, even though the taxpayer is not entitled to a dependency exemption because the individual does not meet the gross income test.

[306] Sec. 21(e)(5).

[307] Sec. 2(b).

if the taxpayer had not waived the exemption to the noncustodial parent), or (3) a relative with respect to whom the taxpayer may claim a dependency exemption.[308] If certain other requirements are satisfied, head of household filing status also may be claimed if the taxpayer is entitled to a dependency exemption with respect to one of the taxpayer's parents.

Reasons for Change

The different present-law tests for the various tax provisions relating to children have been recognized for over a decade as a source of complexity for a significant number of taxpayers and for the IRS. The present-law rules relating to qualifying children are a source of errors for taxpayers both because the rules for each provision are different and because of the complexity of particular rules. The Joint Committee on Taxation[309], the Taxpayer Advocate, the Treasury Department, tax practitioner groups and many others have commented on this complexity and recommended a uniform definition of child.

The Committee believes that substantial simplification to the Internal Revenue Code would be accomplished by establishing a uniform definition of qualifying child to be used for purposes of the dependency exemption, the child tax credit, the earned income credit, the dependent care credit, and head of household filing status. The Committee further believes that the present-law definition of a qualifying child for purposes of the earned income credit, which uses a three-part test based upon age, relationship, and residency (rather than support of the child by the taxpayer), is the appropriate definition to be used for purposes of the uniform definition of qualifying child.

The Committee acknowledges that many taxpayers and their children are subject to court-approved agreements or court orders pursuant to which the parents determine whether the custodial or noncustodial parent may claim a child for purposes of the dependency exemption and the child tax credit, and believes that rules similar to the present-law rules applicable to children of divorced or legally separated parents should continue to apply with respect to the dependency exemption and the child tax credit.

Explanation of Provision

Description of provision

<u>In general</u>

The provision establishes a uniform definition of qualifying child for purposes of the dependency exemption, the child credit, the earned income credit, the dependent care credit, and

[308] Sec. 2(b)(1)(A)(ii), as qualified by sec. 2(b)(3)(B). An individual for whom the taxpayer is entitled to claim a dependency exemption by reason of a multiple support agreement does not qualify the taxpayer for head of household filing status.

[309] Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), Volume II, at 52-58 (April 2001).

head of household filing status. A taxpayer could continue to claim an individual who does not meet the uniform definition of qualifying child as a dependent if the present-law dependency requirements are satisfied. The provision does not modify other parameters of each tax benefit (e.g., the earned income requirements of the earned income credit) or the rules for determining whether individuals other than children qualify for each tax benefit.

Under the uniform definition, in general, a child is a qualifying child of a taxpayer if the child satisfies each of three tests: (1) the child has the same principal place of abode as the taxpayer for more than one half the taxable year; (2) the child has a specified relationship to the taxpayer; and (3) the child has not yet attained a specified age. A tie-breaking rule applies if more than one taxpayer claims a child as a qualifying child.

Under the provision, the present-law support and gross income tests generally do not apply to a child who meets the requirements of the uniform definition of qualifying child.

The provision eliminates the household maintenance test with respect to the dependent care credit and head of household filing status.

Residency test

Under the uniform definition's residency test, a child must have the same principal place of abode as the taxpayer for more than one half of the taxable year. The Committee intends that as is the case under present law, temporary absences due to special circumstances, including absences due to illness, education, business, vacation, or military service, would not be treated as absences.

Relationship test

In order to be a qualifying child under the provision, the child must be the taxpayer's son, daughter, stepson, stepdaughter, brother, sister, stepbrother, stepsister, or a descendant of any such individual. A legally adopted individual of the taxpayer, or an individual who is placed with the taxpayer by an authorized placement agency for adoption by the taxpayer, shall be treated as a child of such taxpayer by blood. A foster child who is placed with the taxpayer by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction is treated as the taxpayer's child.[310]

Age test

Under the provision, the age test varies depending upon the tax benefit involved. In general, a child must be under age 19 (or under age 24 in the case of a full-time student) in order to be a qualifying child.[311] In general, no age limit applies with respect to individuals who are

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[310] The provision eliminates the present-law rule requiring that if a child is the taxpayer's sibling or stepsibling or a descendant of any such individual, the taxpayer must care for the child as if the child were his or her own child.

[311] The provision retains the present-law definition of full-time student set forth in section 151(c)(4).

totally and permanently disabled within the meaning of section 22(e)(3) at any time during the calendar year. The provision retains the present-law requirements that a child must be under age 13 (if he or she is not disabled) for purposes of the dependent care credit, and under age 17 (whether or not disabled) for purposes of the child credit.

Children who support themselves

Under the provision, a child who provides over one half of his or her own support is not considered a qualifying child of another taxpayer.

Tie-breaking rules

If a child would be a qualifying child with respect to more than one individual (e.g., a child lives with his or her mother and grandmother in the same residence) and more than one person claims a benefit with respect to that child, then the following "tie-breaking" rules apply. First, if only one of the individuals claiming the child as a qualifying child is the child's parent, the child is deemed the qualifying child of the parent. Second, if both parents claim the child and the parents do not file a joint return, then the child is deemed a qualifying child first with respect to the parent with whom the child resides for the longest period of time, and second with respect to the parent with the highest adjusted gross income. Third, if the child's parents do not claim the child, then the child is deemed a qualifying child with respect to the claimant with the highest adjusted gross income.

Interaction with present-law rules

Taxpayers may continue to claim an individual who does not meet the uniform definition of qualifying child as a dependent if the present-law dependency requirements (including the gross income and support tests) are satisfied.[312] Thus, for example, a taxpayer may claim a parent as a dependent if the taxpayer provides more than one half of the support of the parent and the parent's gross income is less than the exemption amount.

Children who are U.S. citizens living abroad or non-U.S. citizens living in Canada or Mexico may qualify as a qualifying child, as is the case under the present-law dependency tests. A legally adopted child who does not satisfy the residency or citizenship requirement may nevertheless qualify as a qualifying child (provided other applicable requirements are met) if (1) the child's principal place of abode is the taxpayer's home and (2) the taxpayer is a citizen or national of the United States.

Children of divorced or legally separated parents

The provision generally retains the present-law rule that allows a custodial parent to release the claim to a dependency exemption and the child credit to a noncustodial parent. Thus, the provision generally grandfathers those custodial waivers that are in place and effective on the date of enactment, and generally retains the custodial waiver rule for purposes of the dependency

[312] Individuals who satisfy the present-law dependency tests and who are not qualifying children are referred to as "qualifying relatives" under the provision.

exemption and the child credit for decrees of divorce or separate maintenance or written separation agreements that become effective after the date of enactment. Under the provision, the custodial waiver rules do not affect eligibility with respect to children of divorced or legally separated parents for purposes of the earned income credit, the dependent care credit, and head of household filing status.

Other provisions

A child is not considered a qualifying child unless a taxpayer identification number for the child is provided on the taxpayer's return. For purposes of the earned income credit, a qualifying child is required to have a social security number that is valid for employment in the United States (that is, the child must be a U.S. citizen, permanent resident, or have a certain type of temporary visa).

Effect of provision on particular tax benefits

Dependency exemption

For purposes of the dependency exemption, the provision defines a dependent as a qualifying child or a qualifying relative. The qualifying child test eliminates the support test (other than in the case of a child who provides more than one half of his or her own support), and replaces it with the residency requirement described above. Further, the present-law gross income test does not apply to a qualifying child. The rules relating to multiple support agreements do not apply with respect to qualifying children because the support test does not apply to them. Special tie-breaking rules (described above) apply if more than one taxpayer claims a qualifying child as a dependent under the provision. These tie-breaking rules do not apply if a child constitutes a qualifying child with respect to multiple taxpayers, but only one eligible taxpayer actually claims a dependency exemption for the qualifying child.

The provision permits taxpayers to continue to apply the present-law dependency exemption rules to claim a dependency exemption for a qualifying relative who does not satisfy the qualifying child definition. In such cases, the present-law gross income and support tests, including the special rules for multiple support agreements, the special rules relating to income of handicapped dependents, and the special support test in case of students, continue to apply for purposes of the dependency exemption.

As is the case under present law, a child who provides over half of his or her own support is not considered a dependent of another taxpayer under the provision. Further, an individual shall not be treated as a dependent of a taxpayer if such individual has filed a joint return with the individual's spouse for the taxable year.

Earned income credit

In general, the provision adopts a definition of qualifying child that is similar to the present-law definition under the earned income credit. The present-law requirement that a foster child be cared for as the taxpayer's own child is eliminated. The present-law tie-breaker rule applicable to the earned income credit is used for purposes of the uniform definition of qualifying child. The provision retains the present-law requirement that the taxpayer's principal place of abode must be in the United States.

Child credit

The present-law child credit generally uses the same relationships to define an eligible child as the uniform definition. The age limitation under the provision retains the present-law requirement that the child must be under age 17, regardless of whether the child is disabled.

Dependent care credit

The present-law requirement that a taxpayer maintain a household in order to claim the dependent care credit is eliminated. Thus, if other applicable requirements are satisfied, a taxpayer may claim the dependent care credit with respect to a child who lives with the taxpayer for more than one half the year, even if the taxpayer does not provide more than one half of the cost of maintaining the household.

The rules for determining eligibility for the credit with respect to individuals other than children remain as under present law.

Head of household filing status

Under the provision, a taxpayer qualifies for head of household filing status with respect to a child who is a qualifying child as defined under the provision. An individual who is not a qualifying child will qualify the taxpayer for head of household status only if, as is the case under present law, the individual is a dependent of the taxpayer and the taxpayer is entitled to a dependency exemption for such individual, or the individual is the taxpayer's father or mother and certain other requirements are satisfied. Thus, under the provision a taxpayer is eligible for head of household filing status only with respect to a qualifying child or an individual for whom the taxpayer is entitled to a dependency exemption.

The provision eliminates the present-law requirement that the taxpayer provide over one half the cost of maintaining the household.

Effective Date

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

B. Consolidation of Life and Nonlife Insurance Companies (sec. 511 of the bill and sec. 1504(c)(2) of the Code)

Present Law

Under present law, an affiliated group of corporations means one or more chains of includible corporations connected through stock ownership with a common parent corporation (sec. 1504(a)(1)). The stock ownership requirement consists of an 80-percent voting and value test. In general, an affiliated group of corporations may file a consolidated tax return for Federal income tax purposes.

Life insurance companies (subject to tax under section 801) generally are not treated as includible corporations, and therefore may not be included in a consolidated return of an affiliated group including nonlife-insurance companies, unless the common parent of the group elects to treat the life insurance companies as includible corporations (sec. 1504(c)(2)).

Under the election to treat life insurance companies as includible corporations of an affiliated group, two special 5-year limitation rules apply. The first 5-year rule provides that a life insurance company may not be treated as an includible corporation until it has been a member of the group for the 5 taxable years immediately preceding the taxable year for which the consolidated return is filed (sec. 1504(c)(2)). The second 5-year rule provides that any net operating loss of a nonlife-insurance member of the group may not offset the taxable income of a life insurance member for any of the first 5 years the life and nonlife-insurance corporations have been members of the same affiliated group (sec. 1503(c)(2)). This rule applies to nonlife losses for the current taxable year or as a carryover or carryback.

A separate 35-percent limitation also applies under the election to treat life insurance companies as includible corporations of an affiliated group (sec. 1503(c)(1)). This rule provides that if the non-life-insurance members of the group have a net operating loss, then the amount of the loss that is not absorbed by carrybacks against the nonlife-insurance members' income may offset the life insurance members' income only to the extent of the lesser of: (1) 35 percent of the amount of the loss; or (2) 35 percent of the life insurance members' taxable income. The unused portion of the loss is available as a carryover and is added to subsequent-year losses, subject to the same 35-percent limitation.

Reasons for Change

The Committee believes that desirable simplification of the tax law can be achieved by repeal of the five-year limitation rule providing that a life insurance company may not be treated as an includible corporation until it has been a member of the group for 5 years.

Explanation of Provision

The provision repeals the 5-year limitation providing that a life insurance company may not be treated as an includible corporation until it has been a member of the group for the 5 taxable years immediately preceding the taxable year for which the consolidated return is filed (sec. 1504(c)(2)). The provision also repeals the rule that a life insurance corporation is not an includible corporation unless the common parent makes an election to treat life insurance companies as includible corporations. Thus, under the provision, a life insurance company is treated as an includible corporation starting with the first taxable year for which it becomes a member of the affiliated group and otherwise meets the definition of an includible corporation. The provision retains the 5-year rule of section 1503(c)(2), as well as the 35-percent limitation of present law with respect to any life insurance company that is an includible corporation of an affiliated group.

Effective Date

The provision is effective for taxable years beginning after December 31, 2009. No affiliated group terminates solely by reason of the provision. The provision waives the 5-year waiting period for reconsolidation under section 1504(a)(3), in the case of any corporation that was previously an includible corporation, but was subsequently deemed not to be an includible corporation as a result of becoming a subsidiary of a corporation that was not an includible corporation by reason of the 5-year rule of section 1504(c)(2) (providing that a life insurance company may not be treated as an includible corporation until it has been a member of the group for the 5 taxable years immediately preceding the taxable year for which the consolidated return is filed).

C. Suspension of Reduction of Deductions for Mutual Life Insurance Companies and of Policyholder Surplus Accounts of Life Insurance Companies (sec. 512 of the bill and secs. 809 and 815 of the Code)

Prior and Present Law

Reduction in deductions for policyholder dividends and reserves of mutual life insurance companies (sec. 809)

In general, a corporation may not deduct amounts distributed to shareholders with respect to the corporation's stock. The Deficit Reduction Act of 1984 added a provision to the rules governing insurance companies that was intended to remedy the failure of prior law to distinguish between amounts returned by mutual life insurance companies to policyholders as customers, and amounts distributed to them as owners of the mutual company.

Under the provision, section 809, a mutual life insurance company is required to reduce its deduction for policyholder dividends by the company's differential earnings amount. If the company's differential earnings amount exceeds the amount of its deductible policyholder dividends, the company is required to reduce its deduction for changes in its reserves by the excess of its differential earnings amount over the amount of its deductible policyholder dividends. The differential earnings amount is the product of the differential earnings rate and the average equity base of a mutual life insurance company.

The differential earnings rate is based on the difference between the average earnings rate of the 50 largest stock life insurance companies and the earnings rate of all mutual life insurance companies. The mutual earnings rate applied under the provision is the rate for the second calendar year preceding the calendar year in which the taxable year begins. Under present law, the differential earnings rate cannot be a negative number.

A company's equity base equals the sum of: (1) its surplus and capital increased by 50 percent of the amount of any provision for policyholder dividends payable in the following taxable year; (2) the amount of its nonadmitted financial assets; (3) the excess of its statutory reserves over its tax reserves; and (4) the amount of any mandatory security valuation reserves, deficiency reserves, and voluntary reserves. A company's average equity base is the average of the company's equity base at the end of the taxable year and its equity base at the end of the preceding taxable year.

A recomputation or "true-up" in the succeeding year is required if the differential earnings amount for the taxable year either exceeds, or is less than, the recomputed differential earnings amount. The recomputed differential earnings amount is calculated taking into account the average mutual earnings rate for the calendar year (rather than the second preceding calendar year, as above). The amount of the true-up for any taxable year is added to, or deducted from, the mutual company's income for the succeeding taxable year.

Distributions to shareholders from policyholders surplus account (sec. 815)

Under the law in effect from 1959 through 1983, a life insurance company was subject to a three-phase taxable income computation under Federal tax law. Under the three-phase system, a company was taxed on the lesser of its gain from operations or its taxable investment income (Phase I) and, if its gain from operations exceeded its taxable investment income, 50 percent of such excess (Phase II). Federal income tax on the other 50 percent of the gain from operations was deferred, and was accounted for as part of a policyholder's surplus account and, subject to certain limitations, taxed only when distributed to stockholders or upon corporate dissolution (Phase III). To determine whether amounts had been distributed, a company maintained a shareholders surplus account, which generally included the company's previously taxed income that would be available for distribution to shareholders. Distributions to shareholders were treated as being first out of the shareholders surplus account, then out of the policyholders surplus account, and finally out of other accounts.

The Deficit Reduction Act of 1984 included provisions that, for 1984 and later years, eliminated further deferral of tax on amounts (described above) that previously would have been deferred under the three-phase system. Although for taxable years after 1983, life insurance companies may not enlarge their policyholders surplus account, the companies are not taxed on previously deferred amounts unless the amounts are treated as distributed to shareholders or subtracted from the policyholders surplus account (sec. 815).

Under present law, any direct or indirect distribution to shareholders from an existing policyholders surplus account of a stock life insurance company is subject to tax at the corporate rate in the taxable year of the distribution. Present law (like prior law) provides that any distribution to shareholders is treated as made (1) first out of the shareholders surplus account, to the extent thereof, (2) then out of the policyholders surplus account, to the extent thereof, and (3) finally, out of other accounts.

Reasons for Change

The Committee believes that the provision requiring reduction in certain deductions of mutual life insurance companies may not be operating as intended when originally enacted, and should be suspended temporarily. To provide a measure of parity to stock life insurance companies in light of the suspension of the provision relating to mutual life insurance companies, the Committee bill also temporarily suspends the provision imposing tax on distributions to shareholders of a life insurance company from the policyholder surplus account.

Explanation of Provision

Reduction in deductions for policyholder dividends and reserves of mutual life insurance companies (sec. 809)

The provision provides a zero rate for both the differential earnings rate and recomputed differential earnings rate ("true-up") for a life insurance company's taxable year beginning after December 31, 2003, and before January 1, 2009, under the rules requiring reduction in certain deductions of mutual life insurance companies (sec. 809).

Distributions to shareholders from policyholders surplus account (sec. 815)

The provision suspends for a life insurance company's taxable year beginning after December 31, 2003, and before January 1, 2009, the application of the rules imposing income tax on distributions to shareholders from the policyholders surplus account of a life insurance company (sec. 815). The provision also reverses the order in which distributions reduce the various accounts, so that distributions would be treated as first made out of the policyholders surplus account, to the extent thereof, and then out of the shareholders surplus account, and lastly out of other accounts.

Effective Date

The provision relating to section 809 is effective for taxable years beginning after December 31, 2003.

The provision relating to section 815 is effective for taxable years beginning after December 31, 2003.

D. Section 355 "Active Business Test" Applied to Chains of Affiliated Corporations (sec. 513 of the bill and sec. 355 of the Code)

Present Law

A corporation generally is required to recognize gain on the distribution of property (including stock of a subsidiary) to its shareholders as if such property had been sold for its fair market value. An exception to this rule applies if the distribution of the stock of a controlled corporation satisfies the requirements of section 355 of the Code. To qualify for tax-free treatment under section 355, both the distributing corporation and the controlled corporation must be engaged immediately after the distribution in the active conduct of a trade or business that has been conducted for at least five years and was not acquired in a taxable transaction during that period.[313] For this purpose, a corporation is engaged in the active conduct of a trade or business only if (1) the corporation is directly engaged in the active conduct of a trade or business, or (2) the corporation is not directly engaged in an active business, but substantially all of its assets consist of stock and securities of a corporation it controls that is engaged in the active conduct of a trade or business.[314]

In determining whether a corporation satisfies the active trade or business requirement, the IRS position for advance ruling purposes is that the value of the gross assets of the trade or business being relied on must ordinarily constitute at least 5 percent of the total fair market value of the gross assets of the corporation directly conducting the trade or business.[315] However, if the corporation is not directly engaged in an active trade or business, then the IRS takes the position that the "substantially all" test requires that at least 90 percent of the fair market value of the corporation's gross assets consist of stock and securities of a controlled corporation that is engaged in the active conduct of a trade or business.[316]

Reasons for Change

Prior to a spin-off under section 355, corporate groups that have conducted activities in separate corporate entities must often undergo elaborate restructuring to place 5-year active businesses in the proper entities to satisfy the 5-year active business requirement. If the top-tier corporation of a chain that is being spun off or retained is a holding company, then the

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[313] Section 355(b). If the distributing corporation had no assets other than stock or securities in the controlled corporations immediately before the distribution, then each of the controlled corporations must be engaged immediately after the distribution in the active conduct of a trade or business.

[314] Section 355(b)(2)(A).

[315] Rev. Proc. 2003-3, sec. 4.01(30), 2003-1 I.R.B. 113.

[316] Rev. Proc. 96-30, sec. 4.03(5), 1996-1 C.B. 696; Rev. Proc. 77-37, sec. 3.04, 1977-2 C.B. 568.

requirements regarding the activities of its subsidiaries are more stringent than if the top-tier corporation itself engaged in some active business.

The Committee believes the present law rules create unnecessary complexity.

Explanation of Provision

Under the bill, the active business test is determined by reference to the relevant affiliated group. For the distributing corporation, the relevant affiliated group consists of the distributing corporation as the common parent and all corporations affiliated with the distributing corporation through stock ownership described in section 1504(a)(1)(B) (regardless of whether the corporations are includible corporations under section 1504(b)). The relevant affiliated group for a controlled corporation is determined in a similar manner (with the controlled corporation as the common parent).

Effective Date

The bill applies to distributions after the date of enactment, with three exceptions. The proposal does not apply to distributions (1) made pursuant to an agreement which is binding on the date of enactment and at all times thereafter, (2) described in a ruling request submitted to the IRS on or before the date of enactment, or (3) described on or before the date of enactment in a public announcement or in a filing with the Securities and Exchange Commission. The distributing corporation may irrevocably elect not to have the exceptions described above apply.

The bill also applies to any distribution prior to the date of enactment, but solely for the purpose of determining whether, after the date of enactment, the taxpayer continues to satisfy the requirements of section 355(b)(2)(A).[317]

[317] For example, a holding company taxpayer that had distributed a controlled corporation in a spin-off prior to the date of enactment, in which spin-off the taxpayer satisfied the "substantially all" active business stock test of present law section 355(b)(2)(A) immediately after the distribution, would not be deemed to have failed to satisfy any requirement that it continue that same qualified structure for any period of time after the distribution, solely because of a restructuring that occurs after the date of enactment and that would satisfy the requirements of new section 355(b)(2)(A).

SUBTITLE C – OTHER PROVISIONS

A. Civil Rights Tax Relief (sec. 521 of the bill and new sec. 223 of the Code)

Present Law

Under present law, gross income generally does not include the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) by individuals on account of personal physical injuries (including death) or physical sickness.[318] Expenses relating to recovering such damages are generally not deductible.[319]

Other damages are generally included in income. The related expenses to recover the damages, including attorneys' fees, are generally deductible as miscellaneous itemized deductions to the extent the taxpayer's total miscellaneous itemized deductions exceed two percent of adjusted gross income.[320] Any amount allowable as a deduction is subject to reduction under the overall limitation of itemized deductions if the taxpayer's adjusted gross income exceeds a threshold amount.[321] For purposes of the alternative minimum tax, no deductions are allowed for any miscellaneous itemized deductions.

In some cases, claimants will engage an attorney to represent them on a contingent fee basis. That is, if the claimant recovers damages, a prearranged percentage of the damages will be paid to the attorney; if no damages are recovered, the attorney is not paid a fee. The proper tax treatment of contingent fee arrangements with attorneys has been litigated in recent years. Some courts[322] have held that the entire amount of damages is income and that the claimant is entitled to a miscellaneous itemized deduction subject to both the two-percent floor as an expense for the production of income for the portion paid to the attorney[323] and to the overall limitation on itemized deductions that applies above specified income levels.[324] Other courts

[318] Sec. 104(a)(2).

[319] Sec. 265(a)(1).

[320] Sec. 67(a) and (b).

[321] Sec. 68.

[322] *Kenseth v. Commissioner*, 114 T.C. 399 (2000), *aff'd* 259 F.3d 881 (7th Cir. 2001); *Coady v. Commissioner*, 213 F.3d 1187 (9th Cir. 2000); *Benci-Woodward v. Commissioner*, 219 F.3d 941 (9th Cir. 2000); *Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995).

[323] Sec. 67.

[324] Sec. 68.

have held that the portion of the recovery that is paid directly to the attorney is not income to the claimant, holding that the claimant has no claim of right to that portion of the recovery.[325]

Reasons for Change

The Committee recognizes that civil rights laws provide important protections and remedies to victims of unlawful discrimination. The Committee understands that amounts received by individuals on account of claims of unlawful discrimination may include attorneys' fees and costs and that such attorneys' fees and costs may be larger than the actual award. The Committee believes that it is not appropriate for individuals to be subject to tax on the portion of amounts received on account of unlawful discrimination which is attributable to such fees and costs. The Committee also believes that a clear rule for attorney's fees in such cases will provide simplification.

Explanation of Provision

The provision provides an above-the-line deduction for the portion of amounts received by individuals on account of claims of unlawful discrimination which is attributable to attorneys' fees and costs.

Under the provision, "unlawful discrimination" means an act that is unlawful under certain provisions of any of the following: the Civil Rights Act of 1991, the Congressional Accountability Act of 1995, the National Labor Relations Act, the Fair Labor Standards Act of 1938, the Age Discrimination in Employment Act of 1967, the Rehabilitation Act of 1973, the Employee Retirement Security Income Act of 1974, the Education Amendments of 1972, the Employee Polygraph Protection Act of 1988, the Worker Adjustment and Retraining Notification Act, the Family and Medical Leave Act of 1993, chapter 43 of Title 38 of the United States Code, the Revised Statutes, the Civil Rights Act of 1964, the Fair Housing Act, the Americans with Disabilities Act of 1990, the False Claims Act, any provision of Federal law prohibiting the discharge of an employee, discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted under Federal law, or any provision of State or local law, or common law claims permitted under Federal, State, or local law providing for the enforcement of civil rights or regulating any aspect of the employment relationship, including prohibiting the discharge of an employee, discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law.

Effective Date

The provision is effective for awards received after the date of enactment.

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[325] *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959); *Estate of Arthur Clarks v. United States*, 202 F.3d 854 (6th Cir. 2000); *Srivastava v. Commissioner*, 220 F.3d 353 (5th Cir. 2000). In some of these cases, such as *Cotnam*, State law has been an important consideration in determining that the claimant has no claim of right to the recovery.

B. Increase Section 382 Limitation for Certain Corporations in Bankruptcy (sec. 522 of the bill and sec. 382 of the Code)

Present Law

If a corporation with net operating losses experiences an ownership change, then the annual amount of pre-change net operating loss carryovers that it may use against post-change income is limited. The basic annual post-change limit is the value of the corporation's stock at the time of the ownership change, multiplied by the long-term tax-exempt rate (prescribed by the Treasury department) applicable to the time of the change.

An ownership change occurs if, within a three-year period, there is an increase in ownership by any one or more 5-percent shareholders. A special rule applies to bankruptcy situations. If a corporation is under the jurisdiction of a court in a title 11 or similar case, no ownership change will occur if the shareholders and creditors of the old loss corporation, as a result of owning stock or debt of the old corporation, own at least 50 percent of the stock of the new loss corporation. Only indebtedness held for at least 18 months prior to the date of filing the title 11 or similar case counts for this purpose. In effect, such "old and cold" creditors are treated as persons who had effectively become shareholders of the corporation prior to the ownership change, due to the impending bankruptcy of the corporation.

If "old and cold" creditors dispose of their debt to new persons and those persons become shareholders as a result of owning that debt, the receipt of stock by those persons will be treated as the acquisition of stock by new shareholders, and can trigger an ownership change that causes the section 382 limitation to apply.

Reasons for Change

The Committee believes that some short-term additional relief from the loss carry forward limitation of section 382 is appropriate for corporations that emerge from bankruptcy having experienced an ownership change.

Explanation of Provision

For a limited time period, the bill doubles the amount of the section 382 limitation applicable to corporations that experience an ownership change emerging from bankruptcy in a title 11 or similar case. The bill applies for a period of two taxable years to corporations that experience an ownership change in a title 11 or similar case after December 31, 2002.

Effective Date

The provision is effective for taxable years beginning in 2004 and 2005.

C. Increase in Historic Rehabilitation Credit for Residential Housing for the Elderly (sec. 523 of the bill and sec. 47 of the Code)

Present Law

Rehabilitation credit

Present law provides a credit for rehabilitation expenditures (sec. 47). A 20-percent credit is provided for rehabilitation expenditures with respect to a certified historic structure. For this purpose, a certified historic structure means any building that is listed in the National Register, or that is located in a registered historic district and is certified by the Secretary of the Interior to the Secretary of the Treasury as being of historic significance to the district.

A building is treated as having been substantially rehabilitated only if the rehabilitation expenditures during the 24-month period selected by the taxpayer and ending within the taxable year exceed the greater of the adjusted basis of the building (and its structural components), or $5,000. The taxpayer's depreciable basis in the property is reduced by any rehabilitation credit claimed.

Low-income housing credit

The low-income housing tax credit (sec. 42) may be claimed over a 10-year period for the cost of rental housing occupied by tenants having incomes below specified levels. The credit percentage for newly constructed or substantially rehabilitated housing that is not Federally subsidized is adjusted monthly by the Internal Revenue Service so that the 10 annual installments have a present value of 70 percent of the total qualified expenditures. The credit percentage for new substantially rehabilitated housing that is Federally subsidized and for existing housing that is substantially rehabilitated is calculated to have a present value of 30 percent of qualified expenditures. The aggregate credit authority provided annually to each State is $1.75 per resident, except in the case of projects that also receive financing with proceeds of tax-exempt bonds issued subject to the private activity bond volume limit and certain carry-over amounts. The $1.75 per resident cap is indexed for inflation.

Qualified basis with respect to which the credit may be computed is generally determined as the portion of the eligible basis of the qualified low-income building attributable to the low-income rental units. Qualified basis generally is the taxpayer's depreciable basis in a qualified low-income building. In the case of a taxpayer who claims the rehabilitation credit for a qualified low-income building, the taxpayer's depreciable basis in the building is reduced by the amount of the rehabilitation credit claimed. In addition, eligible basis is reduced by any Federal grant received with respect to the building. A qualified low-income building is a building that meets certain compliance criteria and is depreciable under the modified accelerated cost recovery system ("MACRS").

Reasons for Change

The Committee believes it is important to encourage the creation of quality housing for lower-income seniors and at same time encourage the preservation of historic properties throughout the country.

Explanation of Provision

The provision increases the rehabilitation credit percentage from 20 to 25 percent in the case of certain historic properties. Specifically, the provision increases the present-law 20-percent credit for historic rehabilitation expenses to 25 percent in the case of rehabilitation expenses incurred with respect to a building which is also a low-income housing credit property in which substantially all of the tenants, both those tenants in rent-restricted units and in other residential units, are age 65 or greater. The proposal permits the 25-percent rehabilitation credit to be claimed with respect to all parts of the building, not only those parts on which the taxpayer also claims the low-income housing credit.

The provision also repeals a transition rule to the Tax Reform Act of 1986 permitting the taxpayers who own the property described in sec. 251(d)(4)(X) of the Tax Reform Act of 1986 to use ACRS depreciation, in lieu of MACRS depreciation. This change enables such property to qualify for the provision.

Effective Date

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

D. Modification of Application of Income Forecast Method of Depreciation (sec. 524 of the bill and sec. 167 of the Code)

Present Law

The modified Accelerated Cost Recovery System ("MACRS") does not apply to certain property, including any motion picture film, video tape, or sound recording, or to any other property if the taxpayer elects to exclude such property from MACRS and the taxpayer properly applies a unit-of-production method or other method of depreciation not expressed in a term of years. Section 197 does not apply to certain intangible property, including property produced by the taxpayer or any interest in a film, sound recording, video tape, book or similar property not acquired in a transaction (or a series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof. Thus, the recovery of the cost of a film, video tape, or similar property that is produced by the taxpayer or is acquired on a "stand-alone" basis by the taxpayer may not be determined under either the MACRS depreciation provisions or under the section 197 amortization provisions. The cost recovery of such property may be determined under section 167, which allows a depreciation deduction for the reasonable allowance for the exhaustion, wear and tear, or obsolescence of the property. A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. Section 167(g) provides that the cost of motion picture films, sound recordings, copyrights, books, and patents are eligible to be recovered using the income forecast method of depreciation.

Income forecast method of depreciation

Under the income forecast method, a property's depreciation deduction for a taxable year is determined by multiplying the adjusted basis of the property by a fraction, the numerator of which is the income generated by the property during the year and the denominator of which is the total forecasted or estimated income expected to be generated prior to the close of the tenth taxable year after the year the property was placed in service. Any costs that are not recovered by the end of the tenth taxable year after the property was placed in service may be taken into account as depreciation in such year.

The adjusted basis of property that may be taken into account under the income forecast method only includes amounts that satisfy the economic performance standard of section 461(h). In addition, taxpayers that claim depreciation deductions under the income forecast method are required to pay (or receive) interest based on a recalculation of depreciation under a "look-back" method.

The "look-back" method is applied in any "recomputation year" by (1) comparing depreciation deductions that had been claimed in prior periods to depreciation deductions that would have been claimed had the taxpayer used actual, rather than estimated, total income from the property; (2) determining the hypothetical overpayment or underpayment of tax based on this recalculated depreciation; and (3) applying the overpayment rate of section 6621 of the Code. Except as provided in Treasury regulations, a "recomputation year" is the third and tenth taxable year after the taxable year the property was placed in service, unless the actual income from the property for each taxable year ending with or before the close of such years was within 10 percent of the estimated income from the property for such years.

Reasons for Change

The Committee is aware that taxpayers and the IRS have expended significant resources in auditing and litigating disputes regarding the proper treatment of participations and residuals for purposes of computing depreciation under the income forecast method of depreciation. The Committee understands that these issues relate solely to the timing of a deduction and not to whether such costs are a valid deduction. In addition, the Committee is aware of other disagreements between taxpayers and the Treasury Department regarding the mechanics of the income forecast formula. The Committee believes expending taxpayer and government resources disputing these items is an unproductive use of economic resources. As such, the provision addresses the issues and eliminates any uncertainty as to the each items proper tax treatment.

Explanation of Provision

The provision clarifies that, solely for purposes of computing the allowable deduction for property under the income forecast method of depreciation, participations and residuals may be included in the adjusted basis of the property beginning in the year such property is placed in service, but only if such participations and residuals relate to income to be derived from the property before the close of the tenth taxable year following the year the property is placed in service (as defined in section 167(g)(1)(A)).[326] For purposes of the provision, participations and residuals are defined as costs the amount of which, by contract, varies with the amount of income earned in connection with such property. The provision also clarifies that the income from the property to be taken into account under the income forecast method is the gross income from such property.

The provision also grants authority to the Treasury Department to prescribe appropriate adjustments to the basis of property (and the look-back method) to reflect the treatment of participations and residuals under the provision.

In addition, the provision clarifies that, in the case of property eligible for the income forecast method that the holding in the Associated Patentees decision will continue to constitute a valid method of depreciation and may be used in connection with the income forecast method of accounting. Thus, rather than accounting for participations and residuals as a cost of the property under the income forecast method of depreciation, the taxpayer may elect to deduct those payments as they are paid as under the Associated Patentees decision. This election shall be made on a property-by-property basis and shall be applied consistently with respect to a given property thereafter. The provision also clarifies that distribution costs are not taken into account for purposes of determining the taxpayer's current and total forecasted income with respect to a property.

Effective Date

The provision applies to property placed in service after date of enactment. No inference is intended as to the appropriate treatment under present law. It is intended that the Treasury Department and the IRS expedite the resolution of open cases. In resolving these cases in an expedited and balanced manner, the Treasury Department and IRS are encouraged to take into account the principles of the bill.

E. Additional Advance Refunding for Certain Governmental Bonds (sec. 525 of the bill and sec. 149 of the Code)

Present Law

Interest on bonds issued by States or local governments is excluded from income if the proceeds of the borrowing are used to carry out governmental functions of those entities or the debt is repaid with governmental funds (section 103). Interest on bonds that nominally are issued by States or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private person is taxable unless the purpose of the borrowing is approved specifically in the Code or in a non-Code provision of a revenue Act. These bonds are called private activity bonds. Present law includes several exceptions permitting States or local governments to act as conduits providing tax-exempt financing for private activities. One such exception is the provision of financing for

[326] The provision also clarifies that a taxpayer may deduct participations and residuals in the taxable year paid if such costs are excluded from the adjusted basis of property depreciated under the income forecast method or any similar method.

activities of charitable organizations described in section 501(c)(3) of the Code ("qualified 501(c)(3) bonds").

An advance refunding bond is issued to refund another bond more than 90 days before the redemption of the refunded bond. Under present law, governmental bonds and qualified 501(c)(3) bonds may be advanced refunded, subject to certain limitations described below. Private activity bonds (other than qualified 501(c)(3) bonds) may not be advanced refunded. Bonds eligible for advance refunding can be advance refunded once if the original bond was issued after 1985 or advance refunded twice if the original bond was issued before 1985. Special rules apply for advance refunding bonds under the New York Liberty Zone provisions of the Code (sec. 1400L(e)(3)). "Liberty Advance Refunding Bonds," which may be advance refunded one additional time, are tax-exempt bonds for which all present-law advance refunding authority was exhausted before September 12, 2001, and with respect to which the advance refunding bonds authorized under present law were outstanding on September 11, 2001. In addition, at least 90 percent of the net proceeds of the original bond must have been used to finance facilities located in New York City and must be governmental general obligation bonds issued by either New York City or certain New York State Authorities.

Reasons for Change

Many States are facing difficulties in balancing their budgets. The provision would permit one additional opportunity to refinance debt for the purpose of taking advantage of lower interest rates to the extent possible. The Committee believes that the provision will help prevent tax increases or cuts to vital services in the affected communities.

Explanation of Provision

Under the provision, certain governmental bonds are eligible for an additional advance refunding. To be eligible for an additional refunding, the original bond has to have been part of an issue 90 percent or more of the net proceeds of which were used to finance a public elementary or secondary school in any State in which the State's highest court ruled by opinion issued on November 21, 2002, that the State school funding system violates the State constitution and is constitutionally inadequate. The additional advance refunding bond must be issued before the date which is two years after the date of enactment of the bill.

Effective Date

The bill is effective for advance refunding bonds issued after the date of enactment.

F. Exclusion of Income Derived from Certain Wagers on Horse Races from Gross Income of Nonresident Alien Individuals (sec. 526 of the bill and sec. 872(b) of the Code)

Present Law

Under section 871, certain items of gross income received by a nonresident alien from sources within the United States are subject to a flat 30-percent withholding tax. Gambling winnings received by a nonresident alien from wagers placed in the United States are U.S.-

source and thus generally are subject to this withholding tax, unless exempted by treaty. Currently, several U.S. income tax treaties exempt U.S.-source gambling winnings of residents of the other treaty country from U.S. withholding tax. In addition, no withholding tax is imposed under section 871 on the non-business gambling income of a nonresident alien from wagers on the following games (except to the extent that the Secretary determines that collection of the tax would be administratively feasible): blackjack, baccarat, craps, roulette, and big-6 wheel. Various other (non-gambling-related) items of income of a nonresident alien are excluded from gross income under section 872(b) and are thereby exempt from the 30-percent withholding tax, without any authority for the Secretary to impose the tax by regulation. In cases in which a withholding tax on gambling winnings applies, section 1441(a) of the Code requires the party making the winning payout to withhold the appropriate amount and makes that party responsible for amounts not withheld.

With respect to gambling winnings of a nonresident alien resulting from a wager initiated outside the United States on a pari-mutuel[327] event taking place within the United States, the source of the winnings, and thus the applicability of the 30-percent U.S. withholding tax, depends on the type of wagering pool from which the winnings are paid. If the payout is made from a separate foreign pool, maintained completely in a foreign jurisdiction (*e.g.*, a pool maintained by a racetrack or off-track betting parlor that is showing in a foreign country a simulcast of a horse race taking place in the United States), then the winnings paid to a nonresident alien generally would not be subject to withholding tax, because the amounts received generally would not be from sources within the United States. However, if the payout is made from a "merged" or "commingled" pool, in which betting pools in the United States and the foreign country are combined for a particular event, then the portion of the payout attributable to wagers placed in the United States could be subject to withholding tax. The party making the payment, in this case a racetrack or off-track betting parlor in a foreign country, would be responsible for withholding the tax.

Reasons for Change

The Committee believes that it is appropriate to provide the same exclusion from gross income for winnings paid to a nonresident alien from legal wagers initiated outside the United States in a pari-mutuel pool on a live horse race in the United States, whether the pool is a separate foreign pool or a merged U.S.-foreign pool.

Explanation of Provision

The bill provides an exclusion from gross income under section 872(b) for winnings paid to a nonresident alien resulting from a legal wager initiated outside the United States in a pari-

[327] In pari-mutuel wagering (common in horse racing), odds and payouts are determined by the aggregate bets placed. The money wagered is placed into a pool, the party maintaining the pool takes a percentage of the total, and the bettors effectively bet against each other. Pari-mutuel wagering may be contrasted with fixed-odds wagering (common in sports wagering), in which odds (or perhaps a point spread) are agreed to by the bettor and the party taking the bet and are not affected by the bets placed by other bettors.

mutuel pool on a live horse race in the United States, regardless of whether the pool is a separate foreign pool or a merged U.S.-foreign pool.

Effective Date

The provision applies to proceeds from wagering transactions after September 30, 2003.

G. Federal Reimbursement of Emergency Health Services to Undocumented Aliens (sec. 527 of the bill)

Present Law

Section 4723 of the Balanced Budget Act of 1997, provided $25 million a year for fiscal years 1998-2001, with the funds allotted to the 12 States with the highest number of undocumented aliens (based on estimates by the Immigration and Naturalization Service for 1992 or later). From that allotment, the Secretary reimbursed each State, or political subdivision thereof, for certain emergency health services furnished to undocumented aliens. There is no provision under present law addressing this issue.

Reasons for Change

Hospitals with emergency rooms that participate in Medicare must comply with the Emergency Medical Treatment and Active Labor Act (EMTALA). This requires that hospitals provide appropriate medical screening examinations of individuals who come to those hospitals (whether Medicare-eligible or not) to determine whether an emergency medical condition exists and, if so, provide either further medical examination and treatment to stabilize the medical condition and/or an appropriate transfer to another medical facility that can do so. Some estimates suggest the cost of these unreimbursed medical services now exceeds more than one billion dollars a year. The Committee believes that this proposal attempts to begin to address these needs.

Explanation of Provision

This provision creates an entitlement of $48 million for fiscal year 2004 for Federal reimbursement for providers of emergency health services to undocumented aliens.

Effective Date

This provision is effective beginning in fiscal year 2004.

H. Treatment of Premiums for Mortgage Insurance (sec. 528 of the bill and sec. 163(h) of the Code)

Present Law

Present law provides that qualified residence interest is deductible notwithstanding the general rule that personal interest is nondeductible (sec. 163(h)).

Qualified residence interest is interest on acquisition indebtedness and home equity indebtedness with respect to a principal and a second residence of the taxpayer. The maximum amount of home equity indebtedness is $100,000. The maximum amount of acquisition indebtedness is $1 million. Acquisition indebtedness means debt that is incurred in acquiring constructing, or substantially improving a qualified residence of the taxpayer, and that is secured by the residence. Home equity indebtedness is debt (other than acquisition indebtedness) that is secured by the taxpayer's principal or second residence, to the extent the aggregate amount of such debt does not exceed the difference between the total acquisition indebtedness with respect to the residence, and the fair market value of the residence.

Reasons for Change

The Committee understands that the purpose of the provisions permitting deduction of home mortgage interest is to encourage home ownership while limiting significant disincentives to saving.[328] The Committee believes that it would be consistent with the purpose of the provisions permitting deduction of home mortgage interest to permit the deduction of mortgage insurance premiums. While these premiums are not in the nature of interest, the Committee notes that purchase of such insurance is often demanded by lenders in order for home buyers to obtain financing (depending on the size of the buyer's down payment). The Committee is of the view that permitting deductibility of premiums for this type of insurance connected with home purchases would foster home ownership without a significant disincentive to saving. In the case of higher income taxpayers who may not purchase mortgage insurance, however, the Committee believes the incentive of deductibility becomes unnecessary, and a phase-out is appropriate. It is not intended that prepayments be currently deductible, but rather, that they be deductible only in the period to which they relate. Reporting of payments is generally necessary to administer the provision.

Explanation of Provision

The provision provides that premiums paid or accrued for qualified mortgage insurance by a taxpayer during the taxable year in connection with acquisition indebtedness on a qualified residence of the taxpayer are treated as qualified residence interest and thus deductible. The amount allowable as a deduction under the provision is phased out ratably by 10 percent for each $1,000 by which the taxpayer's adjusted gross income exceeds $100,000 ($500 and $50,000, respectively, in the case of a married individual filing a separate return). Thus, the deduction is not allowed if the taxpayer's adjusted gross income exceeds $110,000 ($55,000 in the case of married individual filing a separate return).

For this purpose, qualified mortgage insurance means mortgage insurance provided by the Veterans Administration, the Federal Housing Administration, or the Rural Housing Administration, and private mortgage insurance (defined in section 2 of the Homeowners Protection Act of 1998).

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[328] H.R. Rep. No. 100-391, pt. 2, at 1031 (1987).

Amounts paid for qualified mortgage insurance after the close of the taxable year are treated as paid in the period to which they are allocated. No deduction is allowed for the unamortized balance if the mortgage is paid before its term (except in the case of qualified mortgage insurance provided by the Veterans Administration or Rural Housing Administration).

Reporting rules apply under the provision.

Effective Date

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

I. Termination of Certain Provisions

Present Law

Budget reconciliation is a procedure under the Congressional Budget Act of 1974 (the "Budget Act") by which Congress implements spending and tax policies contained in a budget resolution. The Budget Act contains numerous rules enforcing the scope of items permitted to be considered under the budget reconciliation process. One such rule, the so-called "Byrd rule," was incorporated into the Budget Act in 1990. The Byrd rule, named after its principal sponsor, Senator Robert C. Byrd, is contained in section 313 of the Budget Act. The Byrd rule generally permits members to raise a point of order against extraneous provisions (those which are unrelated to the goals of the reconciliation process) from either a reconciliation bill or a conference report on such bill.

Under the Byrd rule, a provision is considered to be extraneous if it falls under one or more of the following six definitions: (1) it does not produce a change in outlays or revenues; (2) it produces an outlay increase or revenue decrease when the instructed committee is not in compliance with its instructions; (3) it is outside of the jurisdiction of the committee that submitted the title or provision for inclusion in the reconciliation measure; (4) it produces a change in outlays or revenues which is merely incidental to the nonbudgetary components of the provision; (5) it would increase the deficit for a fiscal year beyond those covered by the reconciliation measure; or (6) it recommends changes in Social Security.

Explanation of Provision

To ensure compliance with the Budget Act, the bill provides that certain provisions of, and amendments made by, the bill do not apply for taxable years beginning after December 31, 2012.

Effective Date

The provision is effective on the date of enactment.