H.R. 2

Managers on the part of the HOUSE	*Managers on the part of the* SENATE
William M. Thomas Mr. Thomas	
Tom DeLay Mr. DeLay	
[redacted]	

H.R. 2—Continued

Managers on the part of the HOUSE	*Managers on the part of the* SENATE
	Mr. Grassley Chuck Grassley
	Mr. Hatch Orrin Hatch
	Mr. Nickles D Nickles
	Mr. Lott Trent Lott
	[redacted]
	[redacted]
	[redacted]

JOINT EXPLANATORY STATEMENT OF THE COMMITTEE OF CONFERENCE

The managers on the part of the House and the Senate at the conference on the disagreeing votes of the two Houses on the amendment of the Senate to the bill (H.R. 2), to provide for reconciliation pursuant to section 201 of the concurrent resolution on the budget for fiscal year 2004, submit the following joint statement to the House and the Senate in explanation of the effect of the action agreed upon by the managers and recommended in the accompanying conference report:

The Senate amendment struck all of the House bill after the enacting clause and inserted a substitute text.

The House recedes from its disagreement to the amendment of the Senate with an amendment that is a substitute for the House bill and the Senate amendment. The differences between the House bill, the Senate amendment, and the substitute agreed to in conference are noted below, except for clerical corrections, conforming changes made necessary by agreements reached by the conferees, and minor drafting and clarifying changes.

Contents

Page

I. ACCELERATION OF CERTAIN PREVIOUSLY ENACTED TAX REDUCTIONS 1

A. Accelerate the Increase in the Child Tax Credit (sec. 101 of the House bill, sec. 106 of the Senate amendment, and sec. 24 of the Code) 1

B. Accelerate Marriage Penalty Relief (secs. 102 and 103 of the House bill, secs. 104 and 105 of the Senate amendment and secs. 1 and 63 of the Code) 4

1. Standard deduction marriage penalty relief 4
2. Accelerate the expansion of the 15-percent rate bracket for married couples filing joint returns 6

C. Accelerate Reductions in Individual Income Tax Rates (secs. 101, 102 and 103 of the House bill, secs. 101, 102 and 103 of the Senate amendment, and secs. 1, and 55 of the Code)..... 9

II. DEPRECIATION AND EXPENSING PROVISIONS 15

A. Special Depreciation Allowance for Certain Property (sec. 201 of the House bill and sec. 168 of the Code)..... 15

B. Increase Section 179 Expensing (sec. 202 of the House bill, sec. 107 of the Senate amendment, and sec. 179 of the Code) 20

C. Five-Year Carryback of Net Operating Losses (sec. 203 of the House bill and secs. 172 and 56 of the Code) 22

III. CAPITAL GAINS AND DIVIDENDS PROVISIONS..... 24

A. Reduce Individual Capital Gains Rates (sec. 301 of the House Bill and sec. 1(h) of the Code)..... 24

B. Treatment of Dividend Income of Individuals (sec. 302 of the House bill, sec. 201 of the Senate amendment, and sec. 1(h) of the Code)..... 26

IV. CORPORATE ESTIMATED TAXES 31

A. Modification to Corporate Estimated Tax Requirements (sec. 401 of the House bill)..... 31

V. REVENUE PROVISIONS..... 32

A. Provisions Designed to Curtail Tax Shelters 32

Page

1. Clarification of the economic substance doctrine (sec. 301 of the Senate amendment and sec. 7701 of the Code) 32
2. Penalty for failure to disclose reportable transactions (sec. 302 of the Senate amendment and sec. 6707A of the Code) 38
3. Modifications to the accuracy-related penalties for listed transactions and reportable transactions having a significant tax avoidance purpose (sec. 303 of the Senate amendment and sec. 6662A of the Code) 41
4. Penalty for understatements from transactions lacking economic substance (sec. 304 of the Senate amendment and sec. 6662B of the Code) 46
5. Modifications to the substantial understatement penalty (sec. 305 of the Senate amendment and sec. 6662of the Code) 48
6. Tax shelter exception to confidentiality privileges relating to taxpayer communications (sec. 306 of the Senate amendment and sec. 7525 of the Code) 50
7. Disclosure of reportable transactions by material advisors (secs. 307 and 308 of the Senate amendment and secs. 6111 and 6707 of the Code) 51
8. Investor lists and modification of penalty for failure to maintain investor lists (secs. 307 and 309 of the Senate amendment and secs. 6112 and 6708 of the Code) .. 54
9. Actions to enjoin conduct with respect to tax shelters and reportable transactions (sec. 310 of the Senate amendment and sec. 7408 of the Code) 56
10. Understatement of taxpayer's liability by income tax return preparer (sec. 311 of the Senate amendment and sec. 6694 of the Code) 57
11. Penalty for failure to report interests in foreign financial accounts (sec. 312 of the Senate amendment and sec. 5321 of Title 31, United States Code) 58
12. Frivolous tax returns and submissions (sec. 313 of the Senate amendment and sec. 6702 of the Code) 59
13. Penalties on promoters of tax shelters (sec. 314 of the Senate amendment and sec. 6700 of the Code) 60
14. Extend statute of limitations for certain undisclosed transactions (sec. 315 of the Senate amendment and sec. 6501 of the Code) 61
15. Deny deduction for interest paid to IRS on underpayments involving certain tax-motivated transactions (sec. 316 of the Senate amendment and sec. 163 of the Code) 62

B. Enron-Related Tax Shelter Related Provisions 63

1. Limitation on transfer and importation of built-in losses (sec. 321 of the Senate amendment and secs. 362 and 334 of the Code) 63
2. No reduction of basis under section 734 in stock held by partnership in corporate partner (sec. 322 of the Senate amendment and sec. 755 of the Code) 64
3. Repeal of special rules for FASITs (sec. 323 of the Senate amendment and secs. 860H through 860L of the Code) 66
4. Expanded disallowance of deduction for interest on convertible debt (sec. 324 of the Senate amendment and sec. 163 of the Code) 69
5. Expanded authority to disallow tax benefits under section 269 (sec. 325 of the Senate amendment and sec. 269 of the Code) 71

Page

6. Modification of controlled foreign corporation - passive foreign investment company coordination rules (sec. 326 of the Senate amendment and sec. 1297 of the Code) 72
7. Modify treatment of closely-held REITs (sec. 327 of the Senate amendment and sec. 856 of the Code) 74

C. Other Corporate Governance Provisions 77

1. Affirmation of consolidated return regulation authority (sec. 331 of the Senate amendment and sec. 1502 of the Code) 77
2. Chief Executive Officer required to sign corporate income tax returns (sec. 332 of the Senate amendment and sec. 6062 of the Code) 82
3. Denial of deduction for certain fines, penalties, and other amounts (sec. 333 of the Senate amendment and sec. 162 of the Code) 83
4. Denial of deduction for punitive damages (sec. 334 of the Senate amendment and sec. 162 of the Code) 85
5. Criminal tax fraud (sec. 335 of the Senate amendment and secs. 7201, 7203, and 7206 of the Code) 86
6. Executive compensation reforms (sec. 336, 337 and 338 of the Senate amendment and sec. 83 and new sec. 409A of the Code) 88
7. Increase in withholding from supplemental wage payments in excess of $1 million (sec. 339 of the Senate amendment and sec. 13273 of the Revenue Reconciliation Act of 1993) 94

D. International Provisions 95

1. Impose mark-to-market on individuals who expatriate (sec. 340 of the Senate amendment and secs. 102, 877, 2107, 2501, 7701 and 6039G of the Code) 95
2. Provisions to discourage corporate expatriation (secs. 341-343 of the Senate amendment and secs. 845(a) and 275(a) and new secs. 7874 and 5000A of the Code) 105
3. Doubling of certain penalties, fines, and interest on underpayments related to certain offshore financial arrangements (sec. 344 of the Senate amendment) 116
4. Effectively connected income to include certain foreign source income (sec. 345 of the Senate amendment and sec. 864 of the Code) 119
5. Determination of basis amounts paid from foreign pension plans (sec. 346 of the Senate amendment and sec. 72 of the Code) 122
6. Recapture of overall foreign losses on sale of controlled foreign corporation stock (sec. 347 of the Senate amendment and sec. 904 of the Code) 123
7. Prevention of mismatching of interest and original issue discount deductions and income inclusions in transactions with related foreign persons (sec. 348 of the Senate amendment and secs. 163 and 267 of the Code) 125
8. Sale of gasoline and diesel fuel at duty-free sales enterprises (sec. 349 of the Senate amendment) 126
9. Repeal of earned income exclusion for citizens or residents living abroad (sec. 350 of the Senate amendment and sec. 911 of the Code) 127

Page

E. Other Revenue Provisions 129

1. Extension of IRS user fees (sec. 351 of the Senate amendment and new sec. 7529 of the Code) 129
2. Add vaccines against hepatitis A to the list of taxable vaccines (sec. 352 of the Senate amendment and sec. 4132 of the Code) 130
3. Disallowance of certain partnership loss transfers (sec. 353 of the Senate amendment and secs. 704, 734, and 743 of the Code) 131
4. Treatment of stripped bonds to apply to stripped interests in bond and preferred stock funds (sec. 354 of the Senate amendment and secs. 305 and 1286 of the Code) 134
5. Reporting of taxable mergers and acquisitions (sec. 355 of the Senate amendment and new sec. 6043A of the Code) 137
6. Minimum holding period for foreign tax credit with respect to withholding taxes on income other than dividends (sec. 356 of the Senate amendment and sec. 901 of the Code) 139
7. Qualified tax collection contracts (sec. 357 of the Senate amendment and new sec. 6306 of the Code) 140
8. Extension of customs user fees (sec. 358 of the Senate amendment) 142
9. Modify qualification rules for tax-exempt property and casualty insurance companies (sec. 359 of the Senate amendment and secs. 501 and 831 of the Code) 143
10. Authorize IRS to enter into installment agreements that provide for partial payment (sec. 360 of the Senate amendment and sec. 6159 of the Code) 144
11. Extend intangible amortization provisions to sports franchises (sec. 361 of the Senate amendment and sec. 197 of the Code) 145
12. Deposits made to suspend the running of interest on potential underpayments (sec. 362 of the Senate amendment and new sec. 6603 of the Code) 146
13. Clarification of rules for payment of estimated tax for certain deemed asset sales (sec. 363 of the Senate amendment and sec. 338 of the Code) 149
14. Limit deduction for charitable contributions of patents and similar property (sec. 364 of the Senate amendment and sec. 170 of the Code) 150
15. Extension of provision permitting qualified transfers of excess pension assets to retiree health accounts (sec. 365 of the Senate amendment, sec. 420 of the Code, and secs. 101, 403, and 408 of ERISA) 152
16. Proration rules for life insurance business of property and casualty insurance companies (sec. 366 of the Senate amendment and sec. 832 of the Code) 154
17. Modify treatment of transfers to creditors in divisive reorganizations (sec. 367 of the Senate amendment and secs. 357 and 361 of the Code) 156
18. Taxation of minor children (sec. 368 of the Senate amendment and sec. 1 of the Code) 157
19. Provide consistent amortization period for intangibles (sec. 369 of the Senate amendment and secs. 195, 248, and 709 of the Code) 160
20. Clarify definition of nonqualified preferred stock (sec. 370 of the Senate amendment and sec. 351 of the Code) 161
21. Establish specific class lives for utility grading costs (sec. 371 of the Senate amendment and sec. 168 of the Code) 162

Page

22. Prohibition on nonrecognition of gain through complete liquidation of holding company (sec. 372 of the Senate amendment and secs. 331 and 332 of the Code).. 164
23. Lease term to include certain service contracts (sec. 373 of the Senate amendment and sec. 168 of the Code)..... 165
24. Exclusion of like-kind exchange property from nonrecognition treatment on the sale or exchange of a principal residence (sec. 374 of the Senate amendment and sec. 121 of the Code)..... 166

F. Other Provisions..... 168

1. Temporary State and local fiscal relief (sec. 381 of the Senate amendment)..... 168
2. Review of State agency blindness and disability determinations (sec. 382 of the Senate amendment)..... 168
3. Prohibition on use of SCHIP funds to provide coverage for childless adults (sec. 383 of the Senate amendment)..... 169
4. Increase Medicaid payments to states with extremely low disproportionate share hospitals (sec. 384 of the Senate amendment)..... 170

VI. SMALL BUSINESS AND AGRICULTURAL PROVISIONS..... 171

A. Small Business Provisions..... 171

1. Exclusion of certain indebtedness of small business investment companies from acquisition indebtedness (sec. 401 of the bill and sec. 514 of the Code)..... 171
2. Repeal of occupational taxes relating to distilled spirits, wine, and beer (sec. 402 of the Senate amendment and secs. 5081, 5091, 5111, 5121, 5131, and 5276 of the Code)..... 172
3. Custom gunsmiths (sec. 403 of the Senate amendment and sec. 4182 of the Code).. 173
4. Simplification of excise tax imposed on bows and arrows (sec. 404 of the Senate amendment and sec. 4161 of the Code)..... 174

B. Agricultural Provisions..... 175

1. Capital gains treatment to apply to outright sales of timber by landowner (sec. 411 of the Senate Amendment and sec. 631 of the Code)..... 175
2. Special rules for livestock sold on account of weather-related conditions (sec. 412 of the Senate amendment and secs. 1033 and 451 of the Code)..... 175
3. Exclusion from gross income for amounts paid under National Health Service Corps loan repayment program (sec. 413 of the of the Senate amendment and sec. 108 of the Code)..... 177
4. Payment of dividends on stock of cooperatives without reducing patronage dividends (sec. 414 of the Senate amendment and sec. 1388 of the Code)..... 178

VII. SIMPLIFICATION AND OTHER PROVISIONS..... 179

A. Establish Uniform Definition of a Qualifying Child (secs. 501 through 508 of the Senate amendment and secs. 2, 21, 24, 32, 151, and 152 of the Code)..... 179

Page

B. Other Simplification Provisions 190

1. Consolidation of life insurance and nonlife companies (sec. 511 of the Senate amendment and sec. 1504 of the Code) 190
2. Suspension of reduction of deductions for mutual life insurance companies and of policyholder surplus accounts of life insurance companies (sec. 512 of the Senate amendment and secs. 809 and 815 of the Code) 191
3. Section 355 "active business test" applied to chains of affiliated corporations (sec. 513 of the Senate amendment and sec. 355 of the Code) 193

C. Other Provisions 196

1. Civil rights tax relief (sec. 521 of the Senate amendment and sec. 62 of the Code) .. 196
2. Increase section 382 limitation for certain corporations in bankruptcy (sec. 522 of the Senate amendment and sec. 382 of the Code) 198
3. Increase in historic rehabilitation credit for residential housing for the elderly (sec. 523 of the Senate amendment and sec. 47 of the Code) 199
4. Modification of application of income forecast method of depreciation (sec. 524 of the Senate amendment and sec. 167 of the Code) 200
5. Additional advance refunding of certain governmental bonds (sec. 525 of the Senate amendment and sec. 149 of the Code) 202
6. Exclusion of income derived from certain wagers on horse races from gross income of nonresident alien individuals (sec. 526 of the Senate amendment and sec. 872(b) of the Code) 203
7. Federal reimbursement of emergency health services furnished to undocumented aliens (sec. 527 of the Senate amendment) 205
8. Treatment of premiums for mortgage insurance (sec. 528 of the Senate amendment and sec. 163 of the Code) 205
9. Sense of the senate on repealing the 1993 tax hike on Social Security Benefits (sec. 529 of the Senate Amendment) 206
10. Flat tax (sec. 530 of the Senate amendment) 207
11. Temporary rate reduction for certain dividends received from controlled foreign corporations (sec. 531 of the Senate amendment and new sec. 965 of the Code) 207
12. Repeal of ten-percent rehabilitation tax credit (sec. 531 of the Senate amendment and section 47 of the Code) 209
13. Income inclusion for certain delinquent child support (sec. 532 of the Senate amendment and sec. 166 of the Code) 210
14. Sense of the Senate regarding the low-income housing tax credit (sec. 533 of the Senate amendment) 211
15. Expensing of investment in broadband equipment (sec. 534 of the Senate amendment and new sec. 191 of the Code) 212
16. Income tax credit for cost of carrying tax-paid distilled spirits in wholesale inventories and in control State bailment warehouses (sec. 535 of the Senate amendment and new sec. 5011 of the Code) 214
17. Contribution in aid of construction (sec. 536 of the Senate amendment and sec. 118 of the Code) 215

Page

18. Travel expenses for spouses (sec. 537 of the Senate amendment and sec. 274 of the Code) 216
19. Certain sightseeing flights exempt from taxes on air transportation (sec. 538 of the Senate amendment and sec. 4281 of the Code) 216
20. Required coverage for reconstructive surgery following mastectomies (sec. 539 of the Senate amendment and new sec. 9813 of the Code) 217
21. Renewal community modifications (secs. 540 and 541 of the Senate amendment and secs. 1400E and 1400H of the Code) 220
22. Combat zone expansions (secs. 542 and 543 of the Senate amendment and sec. 112 of the Code) 222
23. Ratable income inclusion for citrus canker tree payments (sec. 544 of the Senate amendment and sec. 451 and 1033 of the Code) 223
24. Exclusion of certain punitive damage awards (sec. 545 of the Senate amendment and sec. 104 of the Code) 224
25. Repeal of pre-1997 tax on certain imported recycled halons (sec. 546 of the Senate amendment and sec. 4682 of the Code) 225
26. Modification of involuntary conversion rules for businesses affected by the September 11, 2001 terrorist attacks (sec. 547 of the Senate amendment and sec. 1400L of the Code) 226

D. Medicare Provisions (secs. 561-576 of the Senate amendment) 228

E. Provisions Relating to S Corporations (secs. 581-594 of the Senate amendment and sections 1361-1379 of the Code) 233

1. Shareholders of an S corporation 233
2. Termination of election and additions to tax due to passive investment income 234
3. Treatment of S corporation shareholders 234
4. Provisions relating to banks 236
5. Qualified subchapter S subsidiaries 238
6. Elimination of all earnings and profits attributable to pre-1983 years 239

VIII. BLUE RIBBON COMMISSION ON COMPREHENSIVE TAX REFORM (Secs. 601-607 of the Senate Amendment) 241

IX. REIT PROVISIONS 244

A. REIT Modification Provisions (secs. 701-707 of the Senate amendment and secs. 856 and 857 of the Code) 244

B. REIT Savings Provisions (sec. 711 of the Senate amendment and secs. 856, 857 and 860 of the Code) 253

X. EXTENSION OF CERTAIN EXPIRING PROVISIONS 256

A. Tax on Failure to Comply with Mental Health Parity Requirements (sec. 801 of the Senate amendment and sec. 9812 of the Code) 256

Page

B. Extend Alternative Minimum Tax Relief for Individuals (sec. 802 of the Senate amendment and sec. 26 of the Code) 258

C. Extension of Electricity Production Credit for Electricity Produced from Certain Renewable Resources (sec. 803 of the Senate amendment and sec. 45 of the Code)..... 260

D. Extend the Work Opportunity Tax Credit (sec. 804 of thse Senate amendment and sec. 51 of the Code)..... 261

E. Extend the Welfare-To-Work Tax Credit (sec. 805 of the Senate amendment and sec. 51A of the Code)..... 263

F. Taxable Income Limit on Percentage Depletion for Oil and Natural Gas Produced from Marginal Properties (sec. 806 of the Senate amendment and sec. 613A of the Code)..... 265

G. Qualified Zone Academy Bonds (sec. 807 of the Senate amendment and sec. 1397E of the Code)..... 267

H. Cover Over of Tax on Distilled Spirits (sec. 808 of the Senate amendment and sec. 7652(e) of the Code) 269

I. Extend Deduction for Corporate Donations of Computer Technology (sec. 809 of the Senate amendment and sec. 170 of the Code) 270

J. Extension of Credit for Electric Vehicles (sec. 810 of the Senate amendment and sec. 30 of the Code)..... 272

K. Extension of Deduction for Clean-Fuel Vehicles and Clean-Fuel Vehicle Refueling Property (sec. 811 of the Senate amendment and sec. 179A of the Code) 273

L. Adjusted Gross Income Determined by Taking into Account Certain Expenses of Elementary and Secondary School Teachers (sec. 812 of the Senate amendment and sec. 62 of the Code)..... 275

M. Extend Archer Medical Savings Accounts ("MSAs") (sec. 813 of the Senate amendment and sec. 220 of the Code) 277

N. Extension of Expensing of Brownfield Remediation Expenses (sec. 814 of the Senate amendment and sec. 198 of the Code) 279

XI. IMPROVING TAX EQUITY FOR MILITARY PERSONNEL 281

A. Exclusion of Gain on Sale of a Principal Residence by a Member of the Uniformed Services or the Foreign Service (sec. 901 of the Senate amendment and sec. 121 of the Code)..... 281

Page

B. Exclusion from Gross Income of Certain Death Gratuity Payments (sec. 902 of the Senate amendment and sec. 134 of the Code) 282

C. Exclusion for Amounts Received Under Department of Defense Homeowners Assistance Program (sec. 903 of the Senate amendment and sec. 132 of the Code)..... 283

D. Expansion of Combat Zone Filing Rules to Contingency Operations (sec. 94 of the Senate amendment and sec. 7508 of the Code)..... 284

E. Modification of Membership Requirement for Exemption from Tax for Certain Veterans' Organizations (sec. 905 of the Senate amendment and sec. 501 of the Code)..... 286

F. Clarification of Treatment of Certain Dependent Care Assistance Programs Provided to Members of the Uniformed Services of the United States (sec. 906 of the Senate amendment and sec. 134 of the Code) 287

G. Treatment of Service Academy Appointments as Scholarships for Purposes of Qualified Tuition Programs and Coverdell Education Savings Accounts (sec. 907 of the Senate amendment and secs. 529 and 530 of the Code)..... 288

H. Suspension of Tax-Exempt Status of Designated Terrorist Organizations (sec. 908 of the Senate amendment and sec. 501 of the Code) 289

I. Above-the-Line Deduction for Overnight Travel Expenses of National Guard and Reserve Members (sec. 909 of the Senate amendment and sec. 162 of the Code)..... 291

J. Extension of Certain Tax Relief Provisions to Astronauts (sec. 910 of the Senate amendment and secs. 101, 692, and 2201 of the Code)..... 292

XII. SUNSET PROVISION..... 296

A. Termination of Certain Provisions (sec. 1001 of the Senate amendment)..... 296

XIII. TAX COMPLEXITY ANALYSIS 297

I. ACCELERATION OF CERTAIN PREVIOUSLY ENACTED TAX REDUCTIONS

A. Accelerate the Increase in the Child Tax Credit (sec. 101 of the House bill, sec. 106 of the Senate amendment, 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 1, below, shows the scheduled increases of the child tax credit as provided under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA").

Table 1.–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.[1] 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

[1] 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)).

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.[2] 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.

House Bill

Under the House bill, the amount of the child credit is increased to $1,000 for 2003 through 2005.[3] After 2005, the child credit will revert to the levels provided under present law. For 2003, the increased amount of the child credit will be paid in advance beginning in July, 2003, on the basis of information on each taxpayer's 2002 return filed in 2003. Such payments will be made in a manner similar to the advance payment checks issued by the Treasury in 2001 to reflect the creation of the 10-percent regular income tax rate bracket.

Effective date.–The House bill provision is effective for taxable years beginning after December 31, 2002, and before January 1, 2006.

Senate Amendment

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 basis of information on each taxpayer's 2002 return filed in 2003. Advance payments will be

---

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

[3] The increase in refundability to 15 percent of the taxpayer's earned income, scheduled for calendar years 2005 and thereafter, is not accelerated under the provision.

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

Conference Agreement

Under the conference agreement, the amount of the child credit is increased to $1,000 for 2003 and 2004.[4] After 2004, the child credit will revert to the levels provided under present law. For 2003, the increased amount of the child credit will be paid in advance beginning in July, 2003, on the basis of information on each taxpayer's 2002 return filed in 2003. The IRS is not expected to issue advance payment checks to an individual who did not claim the child credit for 2002. Such payments will be made in a manner similar to the advance payment checks issued by the Treasury in 2001 to reflect the creation of the 10-percent regular income tax rate bracket.

Effective date.–The conference agreement provision is effective for taxable years beginning after December 31, 2002, and before January 1, 2005.

[4] The increase in refundability to 15 percent of the taxpayer's earned income, scheduled for calendar years 2005 and thereafter, is not accelerated under the provision.

B. Accelerate Marriage Penalty Relief
(secs. 102 and 103 of the House bill, secs. 104 and 105 of the Senate amendment 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),[5] 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.[6] 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.[7] The

---

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

[6] 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.

[7] 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.

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 2, 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 2.–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
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.

House Bill

The House 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, 2004, and 2005. For taxable years beginning after 2005, the applicable percentages will revert to those allowed under present law, as described above.

Effective date.–The House bill provision is effective for taxable years beginning after December 31, 2002, and before January 1, 2006.

Senate Amendment

The Senate amendment increases in the basic standard deduction amount for joint returns to 195 percent of the basic standard deduction amount for single returns effective for 2003. The Senate amendment also increases in the basic standard deduction amount for joint returns to twice the basic standard deduction amount for single returns effective for 2004. For taxable years beginning after 2004, the applicable percentages will revert to those allowed under present law, as described above.

Effective date.–The Senate amendment provision is effective for taxable years beginning after December 31, 2002 and before January 1, 2005.

Conference Agreement

The conference agreement increases the basic standard deduction amount for joint returns to twice the basic standard deduction amount for single returns effective for 2003 and 2004. For taxable years beginning after 2004, the applicable percentages will revert to those allowed under present law, as described above.

Effective date.–The conference agreement provision is effective for taxable years beginning after December 31, 2002, and before January 1, 2005.

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.[8] 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.

---

[8] 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.

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 3, below, shows the increase in the size of the 15-percent bracket during the phase-in period.

Table 3.–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.

House Bill

The House 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 for taxable years beginning in 2003, 2004, and 2005. For taxable years beginning after 2005, the applicable percentages will revert to those allowed under present law, as described above.

Effective date.–The House bill provision is effective for taxable years beginning after December 31, 2002, and before January 1, 2006.

Senate Amendment

The Senate amendment increases in the size of the 15-percent regular income tax rate bracket for joint returns to 195 percent of the size of the 15-percent regular income tax rate bracket for single returns effective for 2003. The Senate amendment also increases in the size of the 15-percent regular income tax rate bracket for joint returns to twice the size of the 15-percent regular income tax rate bracket for single returns effective for 2004. For taxable years beginning

after 2004, the applicable percentages will revert to those allowed under present law, as described above.

Effective date.–The provision is effective for taxable years beginning after December 31, 2002 and before January 1, 2005.

Conference Agreement

The conference agreement increases 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 for taxable years beginning in 2003 and 2004. For taxable years beginning after 2004, the applicable percentages will revert to those allowed under present law, as described above.

Effective date.–The conference agreement provision is effective for taxable years beginning after December 31, 2002, and before January 1, 2005.

C. Accelerate Reductions in Individual Income Tax Rates (secs. 101, 102 and 103 of the House bill, secs. 101, 102 and 103 of the Senate amendment, 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 4, 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 4.–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

Ten-percent regular income tax rate

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").

Reduction of other regular income tax rates

Prior to EGTRRA, the regular income tax rates were 15 percent, 28 percent, 31 percent, 36 percent, and 39.6 percent.[9] 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.[10]

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

Table 5.–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.

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

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

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

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.

House Bill

Ten-percent regular income tax rate

The House bill accelerates the increase in the taxable income levels for the 10-percent rate bracket now scheduled for 2008 to be effective in 2003, 2004, and 2005. Specifically, for 2003, 2004, and 2005, the proposal increases the taxable income level for the 10-percent regular income tax rate brackets for unmarried 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.

For taxable years beginning after December 31, 2005, the taxable income levels for the 10-percent rate bracket will revert to the levels allowed under present law. Therefore, for 2006 and 2007, the levels will revert to $6,000 for unmarried individuals and $12,000 for married individuals filing jointly. In 2008, the taxable income levels for the 10-percent regular income tax rate brackets will be $7,000 for unmarried individuals and $14,000 for married individuals filing jointly. The taxable income levels for the 10-percent rate bracket will be adjusted annually for inflation for taxable years beginning after December 31, 2008.

Reduction of other regular income tax rates

The House 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 House bill increases the AMT exemption amount for married taxpayers filing a joint return and surviving spouses to $64,000, and for unmarried taxpayers to $43,250, for taxable years beginning in 2003, 2004, and 2005.

Effective date

The House bill provision is effective for taxable years beginning after December 31, 2002 and before January 1, 2006.

Senate Amendment

Ten-percent regular income tax rate

The Senate amendment accelerates the scheduled increase in the taxable income levels for the 10-percent rate bracket. Specifically, beginning in 2003, the Senate amendment 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 Senate amendment 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 Senate amendment increases the AMT exemption amount for married taxpayers filing a joint return and surviving spouses to $60,500, and for unmarried taxpayers to $41,500, for taxable years beginning in 2003, 2004 and 2005.

Effective date.–The Senate amendment provision is effective for taxable years beginning after December 31, 2002 and before January 1, 2006.

Conference Agreement

Ten-percent regular income tax rate

The conference agreement accelerates the increase in the taxable income levels for the 10-percent rate bracket now scheduled for 2008 to be effective in 2003 and 2004. Specifically, for 2003 and 2004, the conference agreement increases the taxable income level for the 10-percent regular income tax rate brackets for unmarried 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.

For taxable years beginning after December 31, 2004, the taxable income levels for the 10-percent rate bracket will revert to the levels allowed under present law. Therefore, for 2005, 2006, and 2007, the levels will revert to $6,000 for unmarried individuals and $12,000 for married individuals filing jointly. In 2008, the taxable income levels for the 10-percent regular income tax rate brackets will be $7,000 for unmarried individuals and $14,000 for married

individuals filing jointly. The taxable income levels for the 10-percent rate bracket will be adjusted annually for inflation for taxable years beginning after December 31, 2008.

Reduction of other regular income tax rates

The conference agreement follows the House bill and the Senate amendment.

Alternative minimum tax exemption amounts

The conference agreement increases the AMT exemption amount for married taxpayers filing a joint return and surviving spouses to $58,000, and for unmarried taxpayers to $40,250 for taxable years beginning in 2003 and 2004.

Effective date

The conference agreement generally is effective for taxable years beginning after December 31, 2002. The conferees recognize that withholding at statutorily mandated rates (such as pursuant to backup withholding under section 3406) has already occurred. The conferees intend that taxpayers who have been overwithheld as a consequence of this obtain a refund of this overwithholding through the normal process of filing an income tax return, and not through the payor. In addition, the conferees anticipate that the Treasury will provide a brief, reasonable period of transition for payors to implement these changes in these statutorily mandated withholding rates.

II. DEPRECIATION AND EXPENSING PROVISIONS

A. Special Depreciation Allowance for Certain Property (sec. 201 of the House bill and sec. 168 of the Code)

Present Law

In general

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system ("MACRS"). Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from 3 to 25 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.

Section 280F limits the annual depreciation deductions with respect to passenger automobiles to specified dollar amounts, indexed for inflation.

Section 167(f)(1) provides that capitalized computer software costs, other than computer software to which section 197 applies, are recovered ratably over 36 months.

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment generally may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year (sec. 179). 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.

Additional first year depreciation deduction

The Job Creation and Worker Assistance Act of 2002[11] ("JCWAA") allows an additional first-year depreciation deduction equal to 30 percent of the adjusted basis of qualified property.[12] The amount of the additional first-year depreciation deduction is not affected by a short taxable year. The additional first-year depreciation deduction is allowed for both regular tax and

[11] Pub. Law No. 107-147, sec. 101 (2002).

[12] The additional first-year depreciation deduction is subject to the general rules regarding whether an item is deductible under section 162 or subject to capitalization under section 263 or section 263A.

alternative minimum tax purposes for the taxable year in which the property is placed in service.[13] The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, there are no adjustments to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to property to which the provision applies. A taxpayer is allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.

In order for property to qualify for the additional first-year depreciation deduction it must meet all of the following requirements. First, the property must be property (1) to which MACRS applies with an applicable recovery period of 20 years or less, (2) water utility property (as defined in section 168(e)(5)), (3) computer software other than computer software covered by section 197, or (4) qualified leasehold improvement property (as defined in section 168(k)(3)).[14] Second, the original use[15] of the property must commence with the taxpayer on or after September 11, 2001.[16] Third, the taxpayer must purchase the property within the applicable time period. Finally, the property must be placed in service before January 1, 2005. An extension of the placed in service date of one year (i.e., to January 1, 2006) is provided for certain property

---

[13] However, the additional first-year depreciation deduction is not allowed for purposes of computing earnings and profits.

[14] A special rule precludes the additional first-year depreciation deduction for any property that is required to be depreciated under the alternative depreciation system of MACRS.

[15] The term "original use" means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer.

If in the normal course of its business a taxpayer sells fractional interests in property to unrelated third parties, then the original use of such property begins with the first user of each fractional interest (i.e., each fractional owner is considered the original user of its proportionate share of the property).

[16] A special rule applies in the case of certain leased property. In the case of any property that is originally placed in service by a person and that is sold to the taxpayer and leased back to such person by the taxpayer within three months after the date that the property was placed in service, the property would be treated as originally placed in service by the taxpayer not earlier than the date that the property is used under the leaseback.

If property is originally placed in service by a lessor (including by operation of section 168(k)(2)(D)(i)), such property is sold within three months after the date that the property was placed in service, and the user of such property does not change, then the property is treated as originally placed in service by the taxpayer not earlier than the date of such sale. A technical correction may be needed so the statute reflects this intent.

with a recovery period of ten years or longer and certain transportation property.[17] Transportation property is defined as tangible personal property used in the trade or business of transporting persons or property.

The applicable time period for acquired property is (1) after September 10, 2001 and before September 11, 2004, but only if no binding written contract for the acquisition is in effect before September 11, 2001, or (2) pursuant to a binding written contract which was entered into after September 10, 2001, and before September 11, 2004.[18] With respect to property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property after September 10, 2001, and before September 11, 2004. Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer. For property eligible for the extended placed in service date, a special rule limits the amount of costs eligible for the additional first year depreciation. With respect to such property, only the portion of the basis that is properly attributable to the costs incurred before September 11, 2004 ("progress expenditures") is eligible for the additional first-year depreciation.[19]

Property does not qualify for the additional first-year depreciation deduction when the user of such property (or a related party) would not have been eligible for the additional first-year depreciation deduction if the user (or a related party) were treated as the owner.[20] For example, if a taxpayer sells to a related party property that was under construction prior to September 11, 2001, the property does not qualify for the additional first-year depreciation deduction. Similarly, if a taxpayer sells to a related party property that was subject to a binding written contract prior to September 11, 2001, the property does not qualify for the additional first-year depreciation deduction. As a further example, if a taxpayer (the lessee) sells property in a sale-leaseback arrangement, and the property otherwise would not have qualified for the additional first-year depreciation deduction if it were owned by the taxpayer-lessee, then the lessor is not entitled to the additional first-year depreciation deduction.

---

[17] In order for property to qualify for the extended placed in service date, the property is required to have a production period exceeding two years or an estimated production period exceeding one year and a cost exceeding $1 million.

[18] Property does not fail to qualify for the additional first-year depreciation merely because a binding written contract to acquire a component of the property is in effect prior to September 11, 2001.

[19] For purposes of determining the amount of eligible progress expenditures, it is intended that rules similar to sec. 46(d)(3) as in effect prior to the Tax Reform Act of 1986 shall apply.

[20] A technical correction may be needed so that the statute reflects this intent.

The limitation on the amount of depreciation deductions allowed with respect to certain passenger automobiles (sec. 280F) is increased in the first year by $4,600 for automobiles that qualify (and do not elect out of the increased first year deduction). The $4,600 increase is not indexed for inflation.

House Bill

The House bill provides an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified property. [21] Qualified property is defined in the same manner as for purposes of the 30-percent additional first-year depreciation deduction provided by the JCWAA except that the applicable time period for acquisition (or self construction) of the property is modified. In addition, property must be placed in service before January 1, 2006 to qualify. [22] Property for which the 50-percent additional first year depreciation deduction is claimed is not eligible for the 30-percent additional first year depreciation deduction.

Under the House bill, in order to qualify the property must be acquired after May 5, 2003 and before January 1, 2006, and no binding written contract for the acquisition is in effect before May 6, 2003.[23] With respect to property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property after May 5, 2003. For property eligible for the extended placed in service date (i.e., certain property with a recovery period of ten years or longer and certain transportation property), a special rule limits the amount of costs eligible for the additional first year depreciation. With respect to such property, only progress expenditures properly attributable to the costs incurred before January 1, 2006 shall be eligible for the additional first year depreciation.[24]

The Committee wishes to clarify that the adjusted basis of qualified property acquired by a taxpayer in a like kind exchange or an involuntary conversion is eligible for the additional first year depreciation deduction.

---

[21] A taxpayer is permitted to elect out of the 50 percent additional first-year depreciation deduction for any class of property for any taxable year.

[22] An extension of the placed in service date of one year (i.e., January 1, 2007) is provided for certain property with a recovery period of ten years or longer and certain transportation property as defined for purposes of the JCWAA.

[23] Property does not fail to qualify for the additional first-year depreciation merely because a binding written contract to acquire a component of the property is in effect prior to May 6, 2003. However, no additional first-year depreciation is permitted on any such component. No inference is intended as to the proper treatment of components placed in service under the 30% additional first-year depreciation provided by the JCWAA.

[24] For purposes of determining the amount of eligible progress expenditures, it is intended that rules similar to sec. 46(d)(3) as in effect prior to the Tax Reform Act of 1986 shall apply.

The House bill also increases the limitation on the amount of depreciation deductions allowed with respect to certain passenger automobiles (sec. 280F of the Code) in the first year by $9,200 (in lieu of the $4,600 provided under the JCWAA) for automobiles that qualify (and do not elect out of the increased first year deduction). The $9,200 increase is not indexed for inflation.

For property eligible for the present law 30-percent additional first year depreciation, the House bill extends the date of the placed in service requirement to property placed in service prior to January 1, 2006 (from January 1, 2005). Thus, property otherwise qualifying for the 30-percent additional first year depreciation deduction will now qualify if placed in service prior to January 1, 2006. The House bill also extends the placed in service date requirement for certain property with a recovery period of ten years or longer and certain transportation property to property placed in service prior to January 1, 2007 (instead of January 1, 2006). In addition, progress expenditures eligible for the 30-percent additional first year depreciation is extended to include costs incurred prior to January 1, 2006 (instead of September 11, 2004).

Effective date.–The House bill applies to property placed in service after May 5, 2003.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill provision with the following modifications. The conference agreement terminates the provision one year earlier than under the House bill provision. Thus, all references to January 1, 2007, and January 1, 2006, are modified to January 1, 2006, and January 1, 2005, respectively. In addition, the conference agreement provides that the increase on the amount of depreciation deductions allowed with respect to certain passenger automobiles (sec. 280F of the Code) in the first year is $7,650 for automobiles that qualify. The $7,650 increase is not indexed for inflation.

Effective date.–The conference agreement applies to taxable years ending after May 5, 2003.

B. Increase Section 179 Expensing
(sec. 202 of the House bill, sec. 107 of the Senate amendment, 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).[25] 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.[26] In general, taxpayers may not elect to expense off-the-shelf computer software.[27]

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.

House Bill

The House bill provision provides that the maximum dollar amount that may be deducted under section 179 is increased to $100,000 for property placed in service in taxable years beginning in 2003, 2004, 2005, 2006, and 2007. In addition, the $200,000 amount is increased to $400,000 for property placed in service in taxable years beginning in 2003, 2004, 2005, 2006 and 2007. The dollar limitations are indexed annually for inflation for taxable years beginning after 2003 and before 2008. The provision also includes off-the-shelf computer software placed in service in a taxable year beginning in 2003, 2004, 2005, 2006, or 2007, as qualifying property.

---

[25] 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).

[26] Section 179(c)(2). A taxpayer may make the election on the original return (whether or not the return is timely), or on an amended return filed by the due date (including extensions) for filing the return for the tax year the property was placed in service. If the taxpayer timely filed an original return without making the election, the taxpayer may still make the election by filing an amended return within six months of the due date of the return (excluding extensions). Treas. Reg. sec. 1.179-5.

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

With respect to a taxable year beginning after 2002 and before 2008, 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.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment, with modifications. The conference agreement provides that the increase in the dollar limitations, as well as the provision relating to off-the-shelf computer software, apply for property placed in service in taxable years beginning in 2003, 2004, and 2005. The conference agreement provides that the dollar limitations are indexed annually for inflation for taxable years beginning after 2003 and before 2006. With respect to a taxable year beginning after 2002 and before 2006, the conference agreement permits taxpayers to make or revoke expensing elections on amended returns without the consent of the Commissioner.

Effective date.–Same as the House bill and the Senate amendment.

C. Five-Year Carryback of Net Operating Losses (sec. 203 of the House bill and secs. 172 and 56 of the Code)

Present Law

A net operating loss ("NOL") is, generally, the amount by which a taxpayer's allowable deductions exceed the taxpayer's gross income. A carryback of an NOL generally results in the refund of Federal income tax for the carryback year. A carryforward of an NOL reduces Federal income tax for the carryforward year.

In general, an NOL may be carried back two years and carried forward 20 years to offset taxable income in such years.[28] Different rules apply with respect to NOLs arising in certain circumstances. For example, a three-year carryback applies with respect to NOLs (1) arising from casualty or theft losses of individuals, or (2) attributable to Presidentially declared disasters for taxpayers engaged in a farming business or a small business. A five-year carryback period applies to NOLs from a farming loss (regardless of whether the loss was incurred in a Presidentially declared disaster area). Special rules also apply to real estate investment trusts (no carryback), specified liability losses (10-year carryback), and excess interest losses (no carryback to any year preceding a corporate equity reduction transaction).

The alternative minimum tax rules provide that a taxpayer's NOL deduction cannot reduce the taxpayer's alternative minimum taxable income ("AMTI") by more than 90 percent of the AMTI (determined without regard to the NOL deduction).

Section 202 of the Job Creation and Worker Assistance Act of 2002[29] ("JCWAA") provided a temporary extension of the general NOL carryback period to five years (from two years) for NOLs arising in taxable years ending in 2001 and 2002. In addition, the five-year carryback period applies to NOLs from these years that qualify under present law for a three-year carryback period (i.e., NOLs arising from casualty or theft losses of individuals or attributable to certain Presidentially declared disaster areas).

A taxpayer can elect to forgo the five-year carryback period. The election to forgo the five-year carryback period is made in the manner prescribed by the Secretary of the Treasury and must be made by the due date of the return (including extensions) for the year of the loss. The election is irrevocable. If a taxpayer elects to forgo the five-year carryback period, then the losses are subject to the rules that otherwise would apply under section 172 absent the provision.[30]

---

[28] Sec. 172.

[29] Pub. Law No. 107-147.

[30] Because JCWAA was enacted after some taxpayers had filed tax returns for years affected by the provision, a technical correction is needed to provide for a period of time in which prior decisions regarding the NOL carryback may be reviewed. Similarly, a technical correction is needed to modify the carryback adjustment procedures of sec. 6411 for NOLs

JCWAA also provided that an NOL deduction attributable to NOL carrybacks arising in taxable years ending in 2001 and 2002, as well as NOL carryforwards to these taxable years, may offset 100 percent of a taxpayer's AMTI.[31]

House Bill

The provision extends the provisions of the five-year carryback of NOLs enacted in JCWAA to NOLs arising in taxable years ending in 2003, 2004, and 2005.[32]

The provision also allows an NOL deduction attributable to NOL carrybacks arising in taxable years ending in 2003, 2004, and 2005, as well as NOL carryforwards to these taxable years, to offset 100 percent of a taxpayer's AMTI.

Effective date.–The five-year carryback provision is effective for net operating losses generated in taxable years ending in 2003, 2004 and 2005. The provision relating to AMTI is effective for NOL carrybacks arising in, and NOL carryforwards to, taxable years ending in 2003, 2004 and 2005.

Senate Amendment

No provision.

Conference Agreement

The conference agreement does not include the House bill provision.

---

arising in 2001 and 2002. These issues were addressed in a letter dated April 15, 2002, sent by the Chairmen and Ranking Members of the House Ways and Means Committee and Senate Finance Committee, as well as in guidance issued by the IRS pursuant to the Congressional letter (Rev. Proc. 2002-40, 2002-23 I.R.B. 1096, June 10, 2002).

[31] Section 172(b)(2) should be appropriately applied in computing AMTI to take proper account of the order that the NOL carryovers and carrybacks are used as a result of this provision. *See* section 56(d)(1)(B)(ii).

[32] Because certain taxpayers may have already filed tax returns (or be in the process of filing tax returns) for taxable years ending in 2003, the proposal contains special rules to provide until November 1, 2003 in which prior decisions regarding the NOL carryback may be reviewed by taxpayers.

III. CAPITAL GAINS AND DIVIDENDS PROVISIONS

A. Reduce Individual Capital Gains Rates (sec. 301 of the House Bill and sec. 1(h) of the Code)

Present Law

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset, any gain generally is included in income. Any net capital gain of an individual is taxed at maximum rates lower than the rates applicable to ordinary income. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

Capital losses generally are deductible in full against capital gains. In addition, individual taxpayers may deduct capital losses against up to $3,000 of ordinary income in each year. Any remaining unused capital losses may be carried forward indefinitely to another taxable year.

A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, (5) certain U.S. publications, (6) certain commodity derivative financial instruments, (7) hedging transactions, and (8) business supplies. In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. Gain from the disposition of depreciable real property is generally not treated as capital gain to the extent of the depreciation allowances in excess of the allowances that would have been available under the straight-line method of depreciation.

The maximum rate of tax on the adjusted net capital gain of an individual is 20 percent. In addition, any adjusted net capital gain which otherwise would be taxed at a 15-percent rate is taxed at a 10-percent rate. These rates apply for purposes of both the regular tax and the alternative minimum tax.

The "adjusted net capital gain" of an individual is the net capital gain reduced (but not below zero) by the sum of the 28-percent rate gain and the unrecaptured section 1250 gain. The net capital gain is reduced by the amount of gain that the individual treats as investment income for purposes of determining the investment interest limitation under section 163(d).

The term "28-percent rate gain" means the amount of net gain attributable to long-term capital gains and losses from the sale or exchange of collectibles (as defined in section 408(m) without regard to paragraph (3) thereof), an amount of gain equal to the amount of gain excluded from gross income under section 1202 (relating to certain small business stock),[33] the net short-

[33] This results in a maximum effective regular tax rate on qualified gain from small business stock of 14 percent.

term capital loss for the taxable year, and any long-term capital loss carryover to the taxable year.

"Unrecaptured section 1250 gain" means any long-term capital gain from the sale or exchange of section 1250 property (i.e., depreciable real estate) held more than one year to the extent of the gain that would have been treated as ordinary income if section 1250 applied to all depreciation, reduced by the net loss (if any) attributable to the items taken into account in computing 28-percent rate gain. The amount of unrecaptured section 1250 gain (before the reduction for the net loss) attributable to the disposition of property to which section 1231 applies shall not exceed the net section 1231 gain for the year.

The unrecaptured section 1250 gain is taxed at a maximum rate of 25 percent, and the 28-percent rate gain is taxed at a maximum rate of 28 percent. Any amount of unrecaptured section 1250 gain or 28-percent rate gain otherwise taxed at a 15-percent rate is taxed at the 15-percent rate.

Any gain from the sale or exchange of property held more than five years that would otherwise be taxed at the 10-percent rate is taxed at an 8-percent rate. Any gain from the sale or exchange of property held more than five years and the holding period for which begins after December 31, 2000, which would otherwise be taxed at a 20-percent rate is taxed at an 18-percent rate.

House Bill

The House bill reduces the 10- and 20 percent rates on the adjusted net capital gain to five and 15 percent, respectively. These lower rates apply to both the regular tax and the alternative minimum tax. The lower rates apply to assets held more than one year.

Effective date.–The provision applies to taxable years ending on or after May 6, 2003,and beginning before January 1, 2013. For taxable years that include May 6, 2003, the lower rates apply to amounts properly taken into account for the portion of the year on or after that date. This generally has the effect of applying the lower rates to capital assets sold or exchanged (and installment payments received) on or after May 6, 2003. In the case of gain and loss taken into account by a pass-through entity, the date taken into account by the entity is the appropriate date for applying this rule.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill, except that the 5-percent tax rate is reduced to zero percent for taxable years beginning after December 31, 2007.

Effective date.–The effective date is the same as the House bill, except that the provision does not apply to taxable years beginning after December 31, 2008.

B. Treatment of Dividend Income of Individuals
(sec. 302 of the House bill, sec. 201 of the Senate amendment, and sec. 1(h) 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.[34]

The rate of tax on the net capital gain of an individual generally is 20 percent (10 percent[35] with respect to income which would otherwise be taxed at the 10- or 15-percent rate).[36] Net capital gain means net gain from the sale or exchange of capital assets held for more than one year in excess of net loss from the sale or exchange of capital assets held not more than one year.

House Bill

Under the House bill, dividends received by an individual shareholder from domestic corporations are taxed at the same rates that apply to net capital gain. This treatment applies for purposes of both the regular tax and the alternative minimum tax. Thus, under the provision, dividends will be taxed at rates of five and 15 percent. [37]

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)),[38] dividends received on the stock are not eligible for the reduced rates. Also, the reduced rates are 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 reduced rates 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 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 reduced rates.

---

[34] Section 105 of the bill reduces the maximum rate to 35 percent.

[35] An eight percent rate applies to property held more than five years.

[36] Section 301 of the bill reduces the capital gain rates to five percent (zero percent for taxable years beginning after 2007) and 15 percent, respectively.

[37] Payments in lieu of dividends are not eligible for the exclusion. *See* sections 6042(a) and 6045(d) relating to statements required to be furnished by brokers regarding these payments.

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

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

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

The tax rate for the accumulated earnings tax (sec. 531) and the personal holding company tax (sec. 541) is reduced to 15 percent.

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

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

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

Senate Amendment

Under the Senate amendment, an individual may exclude from gross income dividends received with respect to stock of a domestic corporation, and stock of a foreign corporation that is regularly tradable on an established securities market.

For taxable years beginning in 2003, 50 percent of the dividend may be excluded from income. For taxable years beginning after 2006, the exclusion no longer applies.

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)),[39] 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, the basis of the share is reduced by the amount of the dividend excludable from income.

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.

---

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

The amount of dividends qualifying for the exclusion that may be paid by a RIC or REIT, 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 foreign personal holding company (as defined in section 552) in either the taxable year of the distribution or the preceding taxable year.

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, or deduction with respect to taxes paid, 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.[40] 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 the taxable percent (*i.e.*, 100 percent less the excludable percentage applicable to dividends received in the taxable year) 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, 2002.

Conference Agreement

The conference agreement follows the House bill taxing dividends at the same rates as net capital gain with the following modifications:

---

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

The 45-day holding period requirement is increased to 60 days during the 120-day period beginning 60 days before the ex-dividend date.

Qualified dividend income includes otherwise qualified dividends received from qualified foreign corporations. The term "qualified foreign corporation" includes a foreign corporation that is eligible for the benefits of a comprehensive income tax treaty with the United States which the Treasury Department determines to be satisfactory for purposes of this provision, and which includes an exchange of information program. The conferees do not believe that the current income tax treaty between the United States and Barbados is satisfactory for this purpose because that treaty may operate to provide benefits that are intended for the purpose of mitigating or eliminating double taxation to corporations that are not at risk of double taxation. The conferees intend that, until the Treasury Department issues guidance regarding the determination of treaties as satisfactory for this purpose, a foreign corporation will be considered to be a qualified foreign corporation if it is eligible for the benefits of a comprehensive income tax treaty with the United States that includes an exchange of information program other than the current U.S.-Barbados income tax treaty. The conferees further intend that a company will be eligible for benefits of a comprehensive income tax treaty within the meaning of this provision if it would qualify for the benefits of the treaty with respect to substantially all of its income in the taxable year in which the dividend is paid.

In addition, a foreign corporation is treated as a qualified foreign corporation with respect to any dividend paid by the corporation with respect to stock that is readily tradable on an established securities market in the United States.[41]

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 foreign personal holding company (as defined in section 552) in either the taxable year of the distribution or the preceding taxable year are not qualified dividends.

Special rules apply in determining a taxpayer's foreign tax credit limitation under section 904 in the case of qualified dividend income. For these purposes, rules similar to the rules of section 904(b)(2)(B) concerning adjustments to the foreign tax credit limitation to reflect any capital gain rate differential will apply to any qualified dividend income. Additionally, it is anticipated that regulations promulgated under this provision will coordinate the operation of the rules applicable to qualified dividend income and capital gain.

In the case of a REIT, an amount equal to the excess of the income subject to the taxes imposed by section 857(b)(1) and the regulations prescribed under section 337(d) for the preceding taxable year over the amount of these taxes for the preceding taxable year is treated as qualified dividend income.

In the case of brokers and dealers who engage in securities lending transactions, short sales, or other similar transactions on behalf of their customers in the normal course of their trade

---

[41] For this purpose, a share shall be treated as so traded if an American Depository Receipt (ADR) backed by such share is so traded.

or business, the conferees intend that the IRS will exercise its authority under section 6724(a) to waive penalties where dealers and brokers attempt in good faith to comply with the information reporting requirements under sections 6042 and 6045, but are unable to reasonably comply because of the period necessary to conform their information reporting systems to the retroactive rate reductions on qualified dividends provided by the conference agreement. In addition, the conferees expect that individual taxpayers who receive payments in lieu of dividends from these transactions may treat the payments as dividend income to the extent that the payments are reported to them as dividend income on their Forms 1099-DIV received for calendar year 2003, unless they know or have reason to know that the payments are in fact payments in lieu of dividends rather than actual dividends. The conferees expect that the Treasury Department will issue guidance as rapidly as possible on information reporting with respect to payments in lieu of dividends made to individuals.

The conference agreement provides that the amendment to section 306 treating certain ordinary income as a dividend for purposes of the rate computation under section 1(h) may also apply to such other provisions as the Secretary may provide, including provisions at the corporate level.

Effective date.–The conference agreement applies to taxable years beginning after December 31, 2002, and beginning before January 1, 2009.

IV. CORPORATE ESTIMATED TAXES

A. Modification to Corporate Estimated Tax Requirements (sec. 401 of the House bill)

Present Law

In general, corporations are required to make quarterly estimated tax payments of their income tax liability (section 6655). For a corporation whose taxable year is a calendar year, these estimated tax payments must be made by April 15, June 15, September 15, and December 15.

House Bill

With respect to corporate estimated tax payments due on September 15, 2003, 52 percent is required to be paid by October 1, 2003.

Effective date.–The provision is effective on the date of enactment.

Senate Amendment

No provision.

Conference Agreement

With respect to corporate estimated tax payments due on September 15, 2003, 25 percent is required to be paid by October 1, 2003.

Effective date.–The provision is effective on the date of enactment.

V. REVENUE PROVISIONS

A. Provisions Designed to Curtail Tax Shelters

1. Clarification of the economic substance doctrine (sec. 301 of the Senate amendment 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.[42]

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.[43]

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:

---

[42] *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).

[43] 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.[44]

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.[45]

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.[46] 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).[47] A third approach regards economic substance and business purpose as "simply

---

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

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

[46] *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.")

[47] *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.[48]

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.[49] 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.[50] 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.[51] In these cases, in assessing whether a

---

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

[48] *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'.").

[49] *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).

[50] *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").

[51] *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.

House Bill

No provision.

Senate Amendment

In general

The Senate amendment clarifies and enhances the application of the economic substance doctrine. The Senate amendment 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.[52]

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

Conjunctive analysis

The Senate amendment 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 Senate amendment, a transaction must satisfy both tests -- i.e., it must change in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position, and the taxpayer must have a substantial non-tax purpose for entering into such transaction (and the transaction is a reasonable means of accomplishing such purpose) -- in order to satisfy the economic substance doctrine. This clarification eliminates the disparity that exists among the circuits regarding the application of the doctrine, and modifies its application in those circuits in which either a change in economic position or a non-tax business purpose (without having both) is sufficient to satisfy the economic substance doctrine.

---

[52] 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.

Non-tax business purpose

The Senate amendment 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.[53]

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)[54] should not be considered to have a substantial non-tax purpose unless a substantial non-tax purpose exists apart from the financial accounting benefits.[55]

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

---

[53] *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.").

[54] 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.

[55] 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)).

Profit potential

Under the Senate amendment, 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 Senate amendment 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.[56] 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.[57]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 Senate amendment to the extent it meets the present law standards.

Transactions with tax-indifferent parties

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

Other rules

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

---

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

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

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

Conference Agreement

The conference agreement does not include the Senate amendment provision.

2. Penalty for failure to disclose reportable transactions (sec. 302 of the Senate amendment and sec. 6707A of the Code)

Present Law

Regulations under section 6011 require a taxpayer to disclose with its tax return certain information with respect to each "reportable transaction" in which the taxpayer participates.[58]

There are six categories of reportable transactions. The first category is any transaction that is the same as (or substantially similar to)[59] 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").[60]

The second category is any transaction that is offered under conditions of confidentiality. In general, if a taxpayer's disclosure of the structure or tax aspects of the transaction is limited in any way by an express or implied understanding or agreement with or for the benefit of any person who makes or provides a statement, oral or written, as to the potential tax consequences

---

[58] 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.

[59] 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).

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

that may result from the transaction, it is considered offered under conditions of confidentiality (whether or not the understanding is legally binding).[61]

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.[62]

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.[63]

The fifth category of reportable transactions refers to any transaction done by certain taxpayers[64] 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.[65]

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.[66]

Under present law, there is no specific penalty for failing to disclose a reportable transaction; however, such a failure may jeopardize a taxpayer's ability to claim that any income tax understatement attributable to such undisclosed transaction is due to reasonable cause, and that the taxpayer acted in good faith.[67]

---

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

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

[63] 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.

[64] 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.

[65] 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.

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

[67] 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

House Bill

No provision.

Senate Amendment

In general

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

Transactions to be disclosed

The Senate amendment does not define the terms "listed transaction"[68] or "reportable transaction," nor does the Senate amendment explain the type of information that must be disclosed in order to avoid the imposition of a penalty. Rather, the Senate amendment 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

---

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.

[68] 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.

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,[69] or a transaction that lacks economic substance) must disclose the imposition of the penalty in reports to the Securities and Exchange Commission for such period as the Secretary shall specify. The 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.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

3. Modifications to the accuracy-related penalties for listed transactions and reportable transactions having a significant tax avoidance purpose (sec. 303 of the Senate amendment 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

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

be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.[70] 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.[71]

Special rules apply with respect to tax shelters.[72] 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.[73] 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.[74]

House Bill

No provision.

Senate Amendment

In general

The Senate amendment 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").[75] The penalty rate and defenses available to avoid the penalty vary depending on whether the transaction was adequately disclosed.

---

[70] Sec. 6662.

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

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

[73] Sec. 6664(c).

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

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

Disclosed transactions

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

Undisclosed transactions

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

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

Once the 30 percent penalty has been included in the Revenue Agent Report, the penalty cannot be compromised for purposes of a settlement without approval of the Commissioner personally or the head of the Office of Tax Shelter Analysis. Furthermore, the IRS is required to 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 the Senate amendment, 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) [76], 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.

---

[76] 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.

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 Senate amendment 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,[77] (2) that there is or was substantial authority for such treatment, and (3) that the taxpayer reasonably believed that such treatment was more likely than not the proper treatment. For this purpose, a taxpayer will be treated as having a reasonable belief with respect to the tax treatment of an item only if such belief (1) is based on the facts and law that exist at the time the tax return (that includes the item) is filed, and (2) relates solely to the taxpayer's chances of success on the merits and does not take into account the possibility that (a) a return will not be audited, (b) the treatment will not be raised on audit, or (c) the treatment will be resolved through settlement if raised.

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

Disqualified tax advisor

A disqualified tax advisor is any advisor who (1) is a material advisor[78] 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[79] 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

---

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

[78] 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).

[79] 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.

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

Disqualified opinion

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

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.

---

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

Conference Agreement

The conference agreement does not include the Senate amendment provision.

4. Penalty for understatements from transactions lacking economic substance (sec. 304 of the Senate amendment 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.[81] The amount of any understatement is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.

Special rules apply with respect to tax shelters.[82] 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.[83] 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.[84]

House Bill

No provision.

---

[81] Sec. 6662.

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

[83] Sec. 6664(c).

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

Senate Amendment

The Senate amendment 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").[85] The penalty rate is 40 percent (reduced to 20 percent if the taxpayer adequately discloses the relevant facts in accordance with regulations prescribed under section 6011). No exceptions (including the reasonable cause or rescission rules) to the penalty would be available under the Senate amendment (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 Senate amendment provision regarding the economic substance doctrine),[86] (2) the transaction was not respected under the rules relating to transactions with tax-indifferent parties (as described in the earlier Senate amendment provision regarding the economic substance doctrine),[87] 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 the Senate amendment, the calculation of an "understatement" is made in the same manner as in the separate Senate amendment provision relating to accuracy-related penalties for listed and reportable avoidance transactions (new sec. 6662A). Thus, the amount of the understatement under the Senate amendment 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), [88] 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.

---

[85] 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.

[86] 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.

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

[88] 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.

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

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

Any understatement to which a penalty is imposed under the Senate amendment 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.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

5. Modifications to the substantial understatement penalty (sec. 305 of the Senate amendment 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).[89]

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.[90]

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.[91]

House Bill

No provision.

Senate Amendment

Definition of substantial understatement

The Senate amendment modifies the definition of "substantial" for corporate taxpayers. Under the Senate amendment, 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 Senate amendment 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 Senate amendment 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.

---

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

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

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

Effective date

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

Conference Agreement

The conference agreement does not include the Senate amendment provision.

6. Tax shelter exception to confidentiality privileges relating to taxpayer communications (sec. 306 of the Senate amendment 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.

House Bill

No provision.

Senate Amendment

The Senate amendment 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.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

7. Disclosure of reportable transactions by material advisors (secs. 307 and 308 of the Senate amendment 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.[92] A "tax shelter" means any investment with respect to which the tax shelter ratio[93] for any investor as of the close of any of the first five years ending after the investment is offered for sale may be greater than two to one and which is: (1) required to be registered under Federal or State securities laws, (2) sold pursuant to an exemption from registration requiring the filing of a notice with a Federal or State securities agency, or (3) a substantial investment (greater than $250,000 and at least five investors).[94]

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.[95]

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,"[96] 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.[97] Certain exceptions are provided with respect to the second category of transactions.[98]

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

---

[92] Sec. 6111(a).

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

[94] Sec. 6111(c).

[95] Sec. 6111(d).

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

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

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

features of the transaction; or (2) the promoter knows, or has reason to know that the offeree's use or disclosure of information relating to the transaction is limited in any other manner.[99]

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

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

House Bill

No provision.

Senate Amendment

Disclosure of reportable transactions by material advisors

The Senate amendment repeals the present law rules with respect to registration of tax shelters. Instead, the Senate amendment requires each material advisor with respect to any reportable transaction (including any listed transaction)[101] 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

---

[99] 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).

[100] Sec. 6707.

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

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.[102]

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

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

Penalty for failing to furnish information regarding reportable transactions

The Senate amendment repeals the present law penalty for failure to register tax shelters. Instead, the Senate amendment 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).[103] 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.[104] 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

---

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

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

[104] 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.

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.

Effective date

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

Conference Agreement

The conference agreement does not include the Senate amendment provision.

8. Investor lists and modification of penalty for failure to maintain investor lists (secs. 307 and 309 of the Senate amendment 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).[105] Recently issued regulations under section 6112 contain rules regarding the list maintenance requirements.[106] In general, the regulations apply to transactions that are potentially abusive tax shelters entered into, or acquired after, February 28, 2003.[107]

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.[108] A material advisor is defined any person who is required to register the transaction under section 6111, or expects to

---

[105] Sec. 6112.

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

[107] 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.

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

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

A potentially abusive tax shelter is any transaction that (1) is required to be registered under section 6111, (2) is a listed transaction (as defined under the regulations under section 6011), or (3) any transaction that a potential material advisor, at the time the transaction is entered into, knows is or reasonably expects will become a reportable transaction (as defined under the new regulations under section 6011).[110]

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.[111]

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).

House Bill

No provision.

Senate Amendment

Investor lists

Each material advisor[112] with respect to a reportable transaction (including a listed transaction)[113] 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 Senate amendment 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.

---

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

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

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

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

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

Penalty for failing to maintain investor lists

The Senate amendment modifies the penalty for failing to maintain the required list by making it a time-sensitive penalty. Thus, a material advisor who is required to maintain an investor list and who fails to make the list available upon written request by the Secretary within 20 business days after the request will be subject to a $10,000 per day penalty. The penalty applies to a person who fails to maintain a list, maintains an incomplete list, or has in fact maintained a list but does not make the list available to the Secretary. The penalty can be waived if the failure to make the list available is due to reasonable cause.[114]

Effective date

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

Conference Agreement

The conference agreement does not include the Senate amendment provision.

9. Actions to enjoin conduct with respect to tax shelters and reportable transactions (sec. 310 of the Senate amendment 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.[115]

House Bill

No provision.

Senate Amendment

The Senate amendment expands this rule so that injunctions may also be sought with respect to the requirements relating to the reporting of reportable transactions[116] and the keeping of lists of investors by material advisors.[117] Thus, under the Senate amendment, an injunction may be sought against a material advisor to enjoin the advisor from (1) failing to file an

---

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

[115] Sec. 7408.

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

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

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

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

Conference Agreement

The conference agreement does not include the Senate amendment provision.

10. Understatement of taxpayer's liability by income tax return preparer (sec. 311 of the Senate amendment 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.

House Bill

No provision.

Senate Amendment

The Senate amendment alters the standards of conduct that must be met to avoid imposition of the first penalty. The Senate amendment 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 Senate amendment 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 Senate amendment 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.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

11. Penalty for failure to report interests in foreign financial accounts (sec. 312 of the Senate amendment 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.[118] 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.[119] 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.[120]

On April 26, 2002, the Secretary of the Treasury submitted to the Congress a report on these reporting requirements.[121] This report, which was statutorily required,[122] 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.

House Bill

No provision.

---

[118] 31 U.S.C. 5314.

[119] 31 U.S.C. 5321(a)(5).

[120] 31 U.S.C. 5322.

[121] *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.

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

Senate Amendment

The Senate amendment 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.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

12. Frivolous tax returns and submissions (sec. 313 of the Senate amendment 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[123] 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)).

House Bill

No provision.

Senate Amendment

The Senate amendment 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 Senate amendment 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 the Senate amendment applies are requests for a collection due process hearing, installment agreements, offers-in-compromise, and taxpayer assistance orders. First, the Senate amendment permits the IRS to dismiss such requests. Second, the Senate amendment 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.

---

[123] Because in general the Tax Court is the only pre-payment forum available to taxpayers, it deals with most of the frivolous, groundless, or dilatory arguments raised in tax cases.

The Senate amendment 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.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

13. Penalties on promoters of tax shelters (sec. 314 of the Senate amendment 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.[124] A qualified false or fraudulent statement is any statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter. A "gross valuation overstatement" means any statement as to the value of any property or services if the stated value exceeds 200 percent of the correct valuation, and the value is directly related to the amount of any allowable income tax deduction or credit.

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

House Bill

No provision.

Senate Amendment

The Senate amendment 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.

---

[124] Sec. 6700.

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

Conference Agreement

The conference agreement does not include the Senate amendment provision.

14. Extend statute of limitations for certain undisclosed transactions (sec. 315 of the Senate amendment and sec. 6501 of the Code)

Present Law

In general, the Code requires that taxes be assessed within three years[125] after the date a return is filed.[126] 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.[127] 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.[128]

House Bill

No provision.

Senate Amendment

The Senate amendment extends the statute of limitations to six years with respect to the entire tax return[129] if a taxpayer required to disclose a listed transaction[130] 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.[131]

---

[125] Sec. 6501(a).

[126] 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)).

[127] Sec. 6501(e).

[128] Sec. 6501(c).

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

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

[131] 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

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

Conference Agreement

The conference agreement does not include the Senate amendment provision.

15. Deny deduction for interest paid to IRS on underpayments involving certain tax-motivated transactions (sec. 316 of the Senate amendment and sec. 163 of the Code)

Present Law

In general, corporations may deduct interest paid or accrued within a taxable year on indebtedness.[132] Interest on indebtedness to the Federal government attributable to an underpayment of tax generally may be deducted pursuant to this provision.

House Bill

No provision.

Senate Amendment

The Senate amendment 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.[133]

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

Conference Agreement

The conference agreement does not include the Senate amendment provision.

---

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.

[132] Sec. 163(a).

[133] 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.

B. Enron-Related Tax Shelter Related Provisions

1. Limitation on transfer and importation of built-in losses (sec. 321 of the Senate amendment 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.[134] 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.[135]

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.[136]

House Bill

No provision.

Senate Amendment

Importation of built-in losses

The Senate amendment provides that if a net built-in loss is imported into the U.S in a tax-free organization or reorganization from persons not subject to U.S. tax, the basis of each property so transferred is its fair market value.[137] A similar rule applies in the case of the tax-free liquidation by a domestic corporation of its foreign subsidiary.

Under the Senate amendment, 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

---

[134] Sec. 351.

[135] Sec. 358.

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

[137] The Senate Amendment also applies to transfers from a tax-exempt organization where gain or loss would not be subject to tax if the property were sold by the organization.

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 Senate amendment 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 Senate amendment, 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.

Conference Report

The conference agreement does not include the Senate amendment provision.

2. No reduction of basis under section 734 in stock held by partnership in corporate partner (sec. 322 of the Senate amendment 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.[138] Similarly, a partner and the partnership generally do not recognize gain or loss on the distribution of partnership property.[139] This includes current distributions and distributions in liquidation of a partner's interest.

Basis of property distributed in liquidation

The basis of property distributed in liquidation of a partner's interest is equal to the partner's tax basis in its partnership interest (reduced by any money distributed in the same

[138] Sec. 721(a).

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

transaction).[140] 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.[141] 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.[142] 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.[143]

House Bill

No provision.

---

[140] Sec. 732(b).

[141] Sec. 754.

[142] Sec. 755(a).

[143] Sec. 755(b).

Senate Amendment

The Senate amendment 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 provision applies to distributions after February 13, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

3. Repeal of special rules for FASITs (sec. 323 of the Senate amendment 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.[144] A FASIT generally is not taxable; the FASIT's taxable income or net loss flows through to the owner of the FASIT.

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

Qualification as a FASIT

To qualify as a FASIT, an entity must: (1) make an election to be treated as a FASIT for the year of the election and all subsequent years;[145] (2) have assets substantially all of which

---

[144] Sections 860H through 860L.

[145] 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

(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.

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.

FASIT election are deemed contributed to the FASIT at that time and, accordingly, any gain (but not loss) on such assets will be recognized at that time.

Transfers to FASITs

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

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

House Bill

No provision.

Senate Amendment

The Senate amendment repeals the special rules for FASITs. The Senate amendment 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 Senate amendment provision is effective after February 13, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

4. Expanded disallowance of deduction for interest on convertible debt (sec. 324 of the Senate amendment 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.[146] 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.[147] 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.[148]

House Bill

No provision.

Senate Amendment

The Senate amendment 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 Senate amendment, 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 Senate amendment 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.–The Senate amendment provision applies to debt instruments that are issued after February 13, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

---

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

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

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

5. Expanded authority to disallow tax benefits under section 269 (sec. 325 of the Senate amendment 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.[149] 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.[150]

House Bill

No provision.

Senate Amendment

The Senate amendment 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,[151] 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.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

---

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

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

[151] 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.

6. Modification of controlled foreign corporation - passive foreign investment company coordination rules (sec. 326 of the Senate amendment and sec. 1297 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[152] and the passive foreign investment company rules.[153] 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.[154]

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,[155] 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).[156] Under the subpart F rules, the United States generally taxes the U.S. 10-percent shareholders of a controlled foreign corporation on their pro

---

[152] Secs. 951-964.

[153] Secs. 1291-1298.

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

[155] Secs. 951-964.

[156] 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.[157]

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,[158] insurance income,[159] and certain income relating to international boycotts and other violations of public policy.[160] 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.[161]

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.[162]

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.[163] 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.[164] 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

---

[157] Sec. 951(a).

[158] Sec. 954.

[159] Sec. 953.

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

[161] Sec. 954.

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

[163] Sec. 1297.

[164] Sec. 1293-1295.

deferral.[165] 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."[166]

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).

House Bill

No provision.

Senate Amendment

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

Effective date.–The 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.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

7. Modify treatment of closely-held REITs (sec. 327 of the Senate amendment 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

[165] Sec. 1291.

[166] Sec. 1296.

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.

House Bill

No provision.

Senate Amendment

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.

Conference Agreement

The conference agreement does not contain the Senate amendment provision.

C. Other Corporate Governance Provisions

1. Affirmation of consolidated return regulation authority (sec. 331 of the Senate amendment 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.[167]

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.[168]

Under this authority, the Treasury Department has issued extensive consolidated return regulations.[169]

In the recent case of *Rite Aid Corp. v. United States*,[170] the Federal Circuit Court of Appeals addressed the application of a particular provision of certain consolidated return loss

---

[167] Sec. 1501.

[168] Sec. 1502.

[169] 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.[171] The particular provision, known as the "duplicated loss" provision,[172] 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.[173]

---

[170] 255 F.3d 1357 (Fed. Cir. 2001), *reh'g denied*, 2001 U.S. App. LEXIS 23207 (Fed. Cir. Oct. 3, 2001).

[171] 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."

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

[173] 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.[174]

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."[175] 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." [176]

---

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.

[174] 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).

[175] 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).

[176] *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.[177]

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.[178]

House Bill

No provision.

Senate Amendment

The bill 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.

---

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.

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

[178] *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).

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 bill 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[179] to the extent the subsidiary had net operating losses or built in losses that could be used later outside the group.[180]

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.[181]

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.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

---

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

[180] 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).

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

2. Chief Executive Officer required to sign corporate income tax returns (sec. 332 of the Senate amendment and sec. 6062 of the Code)

Present Law

The Code requires[182] 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[183] 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[184] ($500,000 in the case of a corporation) or imprisonment of not more than three years, or both, together with the costs of prosecution.

House Bill

No provision.

Senate Amendment

The Senate amendment requires that the chief executive officer of a corporation sign that corporation's income tax returns.[185] If the corporation does not have a chief executive officer, the IRS may designate another officer of the corporation; otherwise, no other person is permitted to sign the income tax return of a corporation. It is intended that the IRS issue general guidance, such as a revenue procedure, to (1) address situations when a corporation does not have a chief executive officer, and (2) define who the chief executive officer is, in situations (for example) when the primary official bears a different title or when a corporation has multiple chief executive officers. It is intended that, in every instance, the highest ranking corporate officer (regardless of title) sign the tax return.

---

[182] Sec. 6062.

[183] Sec. 7206.

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

[185] 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.

The provision does not apply to the income tax returns of mutual funds;[186] they are required to be signed as under present law.

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

Conference Agreement

The conference agreement does not include the Senate amendment.

3. Denial of deduction for certain fines, penalties, and other amounts (sec. 333 of the Senate amendment 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."[187]

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.

House Bill

No provision.

Senate Amendment

The Senate amendment 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,

---

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

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

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 [188] are nondeductible under any provision of the income tax provisions.[189] 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.[190]

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.[191] 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.

---

[188] 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.

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

[190] 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).

[191] 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 provision, such a payment not deductible under section 162 would also not be deductible under section 170.

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

Effective date.–The Senate amendment 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.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

4. Denial of deduction for punitive damages (sec. 334 of the Senate amendment 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.[192] 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.[193] In addition, no deduction is allowed under present law for any fine or similar payment made to a government for violation of any law.[194] 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.[195]

In general, gross income does not include amounts received on account of personal physical injuries and physical sickness.[196] However, this exclusion does not apply to punitive damages.[197]

---

[192] Sec. 162(a).

[193] Sec. 162(c).

[194] Sec. 162(f).

[195] Sec. 162(g).

[196] Sec. 104(a).

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

House Bill

No provision.

Senate Amendment

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

Conference Agreement

The conference agreement does not include the Senate amendment provision.

5. Criminal tax fraud (sec. 335 of the Senate amendment and secs. 7201, 7203, and 7206 of the Code)

Present Law

Attempt to evade or defeat tax

In general, section 7201 imposes a criminal penalty on persons who willfully attempt to evade or defeat any tax imposed by the Code. Upon conviction, the Code provides that the penalty is up to $100,000 or imprisonment of not more than five years (or both). In the case of a corporation, the Code increases the monetary penalty to a maximum of $500,000.

Willful failure to file return, supply information, or pay tax

In general, section 7203 imposes a criminal penalty on persons required to make estimated tax payments, pay taxes, keep records, or supply information under the Code who willfully fails to do so. Upon conviction, the Code provides that the penalty is up to $25,000 or imprisonment of not more than one year (or both). In the case of a corporation, the Code increases the monetary penalty to a maximum of $100,000.

Fraud and false statements

In general, section 7206 imposes a criminal penalty on persons who make fraudulent or false statements under the Code. Upon conviction, the Code provides that the penalty is up to $100,000 or imprisonment of not more than three years (or both). In the case of a corporation, the Code increases the monetary penalty to a maximum of $500,000.

Uniform sentencing guidelines

Under the uniform sentencing guidelines established by 18 U.S.C. 3571, a defendant found guilty of a criminal offense is subject to a maximum fine that is the greatest of: (a) the amount specified in the underlying provision, (b) for a felony[198] $250,000 for an individual or $500,000 for an organization, or (c) twice the gross gain if a person derives pecuniary gain from the offense. This Title 18 provision applies to all criminal provisions in the United States Code, including those in the Internal Revenue Code. For example, for an individual, the maximum fine under present law upon conviction of violating section 7206 is $250,000 or, if greater, twice the amount of gross gain from the offense.

House Bill

No provision.

Senate Amendment

Attempt to evade or defeat tax

The Senate amendment increases the criminal penalty under section 7201 of the Code for individuals to $250,000 and for corporations to $1,000,000. The Senate amendment increases the maximum prison sentence to ten years.

Willful failure to file return, supply information, or pay tax

The Senate amendment increases the criminal penalty under section 7203 of the Code from a misdemeanor to a felony and increases the maximum prison sentence to ten years.

Fraud and false statements

The Senate amendment increases the criminal penalty under section 7206 of the Code for individuals to $250,000 and for corporations to $1,000,000. The Senate amendment increases the maximum prison sentence to five years. The Senate amendment also provides that in no event shall the amount of the monetary penalty under this provision be less than the amount of the underpayment or overpayment attributable to fraud.

Effective date

The provision is effective for offenses committed after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

---

[198] Section 7206 states that making fraudulent or false statements under the Code is a felony. In addition, this offense is a felony pursuant to the classification guidelines of 18 U.S.C. 3559(a)(5).

6. Executive compensation reforms (sec. 336, 337 and 338 of the Senate amendment 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,[199] 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)).

---

[199] *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.

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.[200] 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 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

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

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.[201] 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.[202] 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.

House Bill

No provision.

Senate Amendment

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

The Senate amendment 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

---

[201] 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).

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

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 Senate amendment 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 Senate amendment 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 Senate amendment 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 Senate amendment, if an employer maintains a funded deferred compensation plan,[203] 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.[204]

Under the Senate amendment, 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 Senate amendment, 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

---

[203] A plan includes an agreement or arrangement.

[204] 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.

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.

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 Senate amendment 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)),[205] 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 Senate amendment (e.g., secs. 401(a), 403(b), and 457).

It is not intended that the Senate amendment 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 Senate amendment change the rules applicable to an employer's deduction for nonqualified deferred compensation.

The Senate amendment 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 Senate amendment, 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 Senate amendment applies even if the future right to payment is treated as an unfunded to promise to pay.

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

Effective date

The Senate amendment 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 Senate amendment 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.

---

[205] 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.

The Senate amendment denying deferral of certain stock option and restricted stock gains is effective for exchanges after December 31, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provisions.

7. Increase in withholding from supplemental wage payments in excess of $1 million (sec. 339 of the Senate amendment 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,[206] based on the third lowest income tax rate under the Code (27 percent for 2003).[207]

House Bill

No provision.

Senate Amendment

Under the Senate amendment, 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.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

---

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

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

D. International Provisions

1. Impose mark-to-market on individuals who expatriate (sec. 340 of the Senate amendment 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.[208] 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.[209] 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

---

[208] 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.

[209] 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.

Estate tax rules with respect to expatriates

Nonresident noncitizens generally are subject to estate tax on certain transfers of U.S.-situated property at death.[210] 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.

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

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

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

Gift tax rules with respect to expatriates

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

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

Other tax rules with respect to expatriates

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

In addition, certain information reporting requirements apply. Under these rules, a U.S. citizen who loses his or her citizenship is required to provide a statement to the State Department (or other designated government entity) that includes the individual's social security number,

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

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

Immigration rules with respect to expatriates

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

House Bill

No provision.

Senate Amendment

In general

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

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

Election to be treated as a U.S. citizen

Under the Senate amendment, 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.

Date of relinquishment of citizenship

Under the Senate amendment, 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 Senate amendment 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 Senate amendment, 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 Senate amendment 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).[211] However, the Senate amendment 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

[211] 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).

employer (sec. 457(b)), or an IRA (sec. 408). The special retirement plan rule applies also, to the extent provided in regulations, to any foreign plan or similar retirement arrangement or program. An interest in a trust that is part of a qualified retirement plan or other arrangement that is subject to the special retirement plan rule is not subject to the rules for interests in trusts (discussed below).

Under the special rule, an amount equal to the present value of the individual's vested, accrued benefit under a qualified retirement plan is treated as having been received by the individual as a distribution under the plan on the day before the individual's relinquishment of citizenship or termination of residency. It is not intended that the plan would be deemed to have made a distribution for purposes of the tax-favored status of the plan, such as whether a plan may permit distributions before a participant has severed employment. In the case of any later distribution to the individual from the plan, the amount otherwise includible in the individual's income as a result of the distribution is reduced to reflect the amount previously included in income under the special retirement plan rule. The amount of the reduction applied to a distribution is the excess of: (1) the amount included in income under the special retirement plan rule over (2) the total reductions applied to any prior distributions. However, under the 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 Senate amendment, 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.

Interests in trusts

Under the Senate amendment, 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.

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

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

Qualified trusts.–If an individual has an interest in a qualified trust, the amount of unrealized gain allocable to the individual's trust interest is calculated at the time of expatriation or residency termination. In determining this amount, all contingencies and discretionary

interests are assumed to be resolved in the individual's favor (i.e., the individual is allocated the maximum amount that he or she could receive). The mark-to-market tax imposed on such gains is collected when the individual receives distributions from the trust, or if earlier, upon the individual's death. Interest is charged for the period the tax is deferred at a rate two percentage points higher than the rate normally applicable to individual underpayments.

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

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

Mark-to-market taxes become due if the trust ceases to be a qualified trust, the individual disposes of his or her qualified trust interest, or the individual dies. In such cases, the amount of mark-to-market tax equals the lesser of (1) the tax calculated under the rules for nonqualified trust interests as of the date of the triggering event, or (2) the deferred tax amount with respect to the trust interest as of that date.

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

Coordination with present-law alternative tax regime

The Senate amendment 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 Senate amendment, 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 Senate amendment 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 Senate amendment 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 Senate amendment 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.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

2. Provisions to discourage corporate expatriation (secs. 341-343 of the Senate amendment and secs. 845(a) and 275(a) and new secs. 7874 and 5000A of the Code)

(a) Tax treatment of inverted corporate entities

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[212] and the passive foreign investment company rules.[213] A foreign tax credit is generally available to offset, in whole or in part, the U.S. tax owed on this foreign-source income, whether repatriated as an actual dividend or included under one of the anti-deferral regimes.

U.S. taxation of foreign corporations

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

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

U.S. tax treatment of inversion transactions

Under present law, 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

[212] Secs. 951-964.

[213] Secs. 1291-1298.

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.

House Bill

No provision.

Senate Amendment

In general

The Senate amendment 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;[214] (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.[215]

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.

---

[214] 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.

[215] 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.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

(b) Excise tax on stock compensation of insiders in inverted corporations

Present Law

The income taxation of a nonstatutory[216] 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.[217] 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.

House Bill

No provision.

Senate Amendment

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

---

[216] 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.

[217] 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.

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,[218] 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)),[219] 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[220] (or right to payment) granted by the inverted corporation (or any member of the corporation's expanded affiliated group) to any person in connection with the performance of services by a disqualified individual for such corporation (or member of the corporation's expanded affiliated group) if the value of the payment or right is based on, or determined by reference to, the value or change in value of stock of such corporation (or any member of the corporation's expanded affiliated group). In determining whether such compensation exists and valuing such compensation, all restrictions, other than non-lapse restrictions, are ignored. Thus, the excise tax applies, and the value subject to the tax is determined, without regard to whether such specified stock compensation is subject to a substantial risk of forfeiture or is exercisable at the time of the inversion transaction. Specified stock compensation includes compensatory stock and restricted stock grants, compensatory stock options, and other forms of stock-based compensation, including stock appreciation rights, phantom stock, and phantom stock options. Specified stock compensation also includes nonqualified deferred compensation that is treated as though it were invested in stock or stock options of the inverting corporation (or member). For example, the provision applies to a disqualified individual's deferred compensation if company stock is one of the actual or deemed investment options under the nonqualified deferred compensation plan.

---

[218] 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.

[219] 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.

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

Specified stock compensation 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.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

(c) Reinsurance of United States risks in foreign jurisdictions

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.[221] 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.[222] 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.

House Bill

No provision.

Senate Amendment

The Senate amendment 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[223] 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

---

[221] Sec. 845(a).

[222] 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).

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

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.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

3. Doubling of certain penalties, fines, and interest on underpayments related to certain offshore financial arrangements (sec. 344 of the Senate amendment)

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.

Voluntary disclosure initiative

A taxpayer's timely, voluntary disclosure of a substantial unreported tax liability has long been an important factor in deciding whether the taxpayer's case should ultimately be referred for criminal prosecution. The voluntary disclosure must be truthful, timely, and complete. The taxpayer must show a willingness to cooperate (as well as actual cooperation) with the IRS in determining the correct tax liability. The taxpayer must make good-faith arrangements with the IRS to pay in full the tax, interest, and any penalties determined by the IRS to be applicable. A voluntary disclosure does not guarantee immunity from prosecution. It creates no substantive or procedural rights for taxpayers.

House Bill

No provision.

Senate Amendment

The Senate amendment 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 either the OVCI or the Treasury Department's voluntary disclosure initiative, which applies to the taxpayer by reason of the taxpayer's underpayment of U.S. income tax liability through certain financing arrangement, but did not participate in either program.

Effective date.–The Senate amendment generally is effective with respect to a taxpayer's open tax years on or after May 8, 2000.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

4. Effectively connected income to include certain foreign source income (sec. 345 of the Senate amendment and sec. 864 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.[224] 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.

[224] 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").[225] 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.[226] 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.[227] 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.[228]

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.[229] 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.[230] 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.[231] 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

---

[225] Section 864(c).

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

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

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

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

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

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

United States through the foreign person's U.S. office or other fixed place of business.[232] 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.[233] 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.[234] 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.[235] Moreover, income from notional principal contracts (such as interest rate swaps) generally is sourced based on the residence of the recipient of the income.[236]

House Bill

No provision.

Senate Amendment

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 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,

---

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

[233] Sections 861 through 865.

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

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

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

or the foreign person is a corporation whose principal business is trading in stocks or securities for its own account.

Effective date.–The Senate amendment provision is effective for taxable years beginning after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

5. Determination of basis amounts paid from foreign pension plans (sec. 346 of the Senate amendment and sec. 72 of the Code)

Present Law

Distributions from retirement plans are includible in gross income under the rules relating to annuities[237] 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.[238] 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 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.

---

[237] Sections 72 and 402.

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

House Bill

No provision.

Senate Amendment

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

Conference Agreement

The conference agreement does not include the Senate amendment provision.

6. Recapture of overall foreign losses on sale of controlled foreign corporation stock (sec. 347 of the Senate amendment and sec. 904 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.[239] 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.[240] 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.[241] 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 foreign-source income in a given year (the "50-percent limit"). Taxpayers may elect to recapture a larger percentage of such losses.

---

[239] Section 904(a).

[240] Section 904(f).

[241] Section 904(f)(1).

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.[242] 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.[243]

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).[244] 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.

House Bill

No provision.

---

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

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

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

Senate Amendment

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 Senate amendment provision is effective as of the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

7. Prevention of mismatching of interest and original issue discount deductions and income inclusions in transactions with related foreign persons (sec. 348 of the Senate amendment 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.

House Bill

No provision.

Senate Amendment

The Senate amendment generally 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.

Effective date.–The Senate amendment provision is effective for payments accrued on or after May 8, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

8. Sale of gasoline and diesel fuel at duty-free sales enterprises (sec. 349 of the Senate amendment)

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. The duty-free statute does not contain any limitation on what goods may qualify for duty-free treatment.

House Bill

No provision.

Senate Amendment

The Senate amendment 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 Senate amendment provision is effective on the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

9. Repeal of earned income exclusion for citizens or residents living abroad (sec. 350 of the Senate amendment 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.

House Bill

No provision.

Senate Amendment

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

Effective date.–The Senate amendment provision is effective for taxable years beginning after December 31, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

E. Other Revenue Provisions

1. Extension of IRS user fees (sec. 351 of the Senate amendment 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[245] extended the statutory authorization for these user fees[246] through September 30, 2003.

House Bill

No provision.

Senate Amendment

The Senate amendment extends the statutory authorization for these user fees through September 30, 2013. The Senate amendment also moves the statutory authorization for these fees into the Code.[247]

Effective date.–The Senate amendment 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.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

---

[245] 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).

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

[247] The provision 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).

2. Add vaccines against hepatitis A to the list of taxable vaccines (sec. 352 of the Senate amendment and sec. 4132 of the Code)

Present Law

A manufacturer's excise tax is imposed at the rate of 75 cents per dose[248] 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.

House Bill

No provision.

Senate Amendment

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

Effective date.–The Senate amendment 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.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

[248] Sec. 4131.

3. Disallowance of certain partnership loss transfers (sec. 353 of the Senate Amendment 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.[249] The partnership takes the property at an adjusted basis equal to the contributing partner's adjusted basis in the property.[250] The contributing partner increases its basis in its partnership interest by the adjusted basis of the contributed property.[251] 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.[252] 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.[253]

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.[254] If the contributing partner's interest is liquidated, there is no specific guidance preventing the allocation of the built-in loss to the remaining partners. Thus, it appears that losses can be "transferred" to other partners where the contributing partner no longer remains a partner.

Transfers of partnership interests

Under present law, a partnership does not adjust the basis of partnership property following the transfer of a partnership interest unless the partnership has made a one-time election under section 754 to make basis adjustments.[255] 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

---

[249] Sec. 721.

[250] Sec. 723.

[251] Sec. 722.

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

[253] 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).

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

[255] Sec. 743(a).

transferee's basis in its partnership interest.[256] 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.[257] 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).[258] 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).[259]

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.[260] 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).[261] To the extent the adjusted basis of the distributed properties increases (or loss is recognized), the partnership's adjusted basis in its properties is decreased by a like amount; likewise, to the extent the adjusted basis of the distributed properties decrease (or gain is recognized), the partnership's adjusted basis in its properties is increased by a like amount. Under these rules, a partnership with no election in effect under section 754 may distribute property with an adjusted basis lower than the distributee partner's proportionate share of the adjusted basis of all partnership property and leave the remaining partners with a smaller net built-in gain or a larger net built-in loss than before the distribution.

---

[256] Sec. 743(b).

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

[258] Sec. 732(b).

[259] Sec. 732(a).

[260] Sec. 734(a).

[261] Sec. 734(b).

House Bill

No provision.

Senate Amendment

Contributions of property

Under the Senate amendment, 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.[262]

Transfers of partnership interests

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

---

[262] 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.

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 Senate amendment, 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.

Conference Agreement

The conference agreement does not contain the provision in the Senate amendment.

4. Treatment of stripped bonds to apply to stripped interests in bond and preferred stock funds (sec. 354 of the Senate amendment 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.[263]

In addition to general common law assignment of income principles, specific statutory rules have been enacted to address certain specific types of stripping transactions, such as transactions involving stripped bonds and stripped preferred stock (which are discussed below).[264] However, there are no specific statutory rules that address stripping transactions with respect to common stock or other equity interests (other than preferred stock).[265]

---

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

[264] 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,

Stripped bonds

Special rules are provided with respect to the purchaser and "stripper" of stripped bonds.[266] 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.[267] 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.[268] The OID on the stripped bond or coupon is includible in gross income under the general OID periodic income inclusion rules.

A taxpayer who strips a bond and disposes of either the stripped bond or one or more stripped coupons must allocate his basis, immediately before the disposition, in the bond (with the coupons attached) between the retained and disposed items.[269] 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

---

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).

[265] However, in *Estate of Stranahan v. Commissioner*, 472 F.2d 867 (6th Cir. 1973), the court held that where a taxpayer sold an interest in stock dividends, with no personal obligation to produce the income supporting the dividends, the transaction was treated as a sale of an income interest.

[266] Sec. 1286.

[267] Sec. 1286(e).

[268] Sec. 1286(a).

[269] 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.

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.[270]

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.[271] 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.[272] 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.[273]

House Bill

No provision.

Senate Amendment

The Senate amendment 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 Senate amendment applies only to cases in which the present-law rules for stripped bonds and stripped preferred stock do not already apply to such interests.

---

[270] 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)).

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

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

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

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 the Senate amendment 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,[274] *modifying and superceding* Rev. Proc. 2002-16.[275]

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

Conference Agreement

The conference agreement does not include the Senate amendment provision.

5. Reporting of taxable mergers and acquisitions (sec. 355 of the Senate amendment 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)).

House Bill

No provision.

Senate Amendment

Under the Senate amendment, 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

[274] 2002-43 I.R.B. 753.

[275] 2002-9 I.R.B. 572.

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 Senate amendment provision is effective for acquisitions after the date of enactment of the proposal.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

6. Minimum holding period for foreign tax credit with respect to withholding taxes on income other than dividends (sec. 356 of the Senate amendment 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.

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.[276] 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.

House Bill

No provision.

Senate Amendment

The Senate amendment 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 Senate amendment does not apply to foreign tax credits that are subject to the present-law disallowance with respect to dividends. The Senate amendment 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 Senate amendment. In addition, the Senate amendment authorizes the Treasury Department to issue regulations providing that the Senate amendment does not apply in appropriate cases.

---

[276] Sec. 901(k).

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

Conference Agreement

The conference agreement does not include the Senate amendment provision.

7. Qualified tax collection contracts (sec. 357 of the Senate amendment 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.[277] 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[278] that IRS collected $3.1 million attributable to the private debt collection company efforts; expenses were also $3.1 million. In addition, there were lost opportunity costs of $17 million to the IRS because collection personnel were diverted from their usual collection responsibilities to work on the pilot.

The IRS has 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.[279]

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

---

[277] Sec. 7801(a).

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

[279] 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.

States.[280] That provision does not apply to the collection of debts under the Internal Revenue Code.[281]

On February 3, 2003, the President submitted to the Congress his fiscal year 2004 budget proposal,[282] which proposed the use of private debt collection companies to collect Federal tax debts.

House Bill

No provision.

Senate Amendment

The Senate amendment permits the IRS to use private debt collection companies to locate and contact taxpayers owing outstanding tax liabilities[283] of any type[284] 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.[285] 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.[286] If the taxpayer cannot pay in full immediately, the private debt collection company offers the

---

[280] 31 U.S.C. sec. 3718.

[281] 31 U.S.C. sec. 3718(f).

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

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

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

[285] 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. It is intended, however, that the IRS vigorously protect the privacy of confidential taxpayer information by disclosing the least amount of information possible to contractors consistent with the effective operation of the provision.

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

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 Senate amendment 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 Senate amendment provides that the United States shall not be liable for any act or omission of any person performing services under a qualified debt collection contract. This is designed to encourage these persons to protect taxpayers' rights to the maximum extent possible, since they and their employers will be liable for violations; they will not be able to transfer liability for violations to the United States, which might cause them to be more lax in preventing violations.

The Senate amendment 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. The provision prohibits the payment of fees for all services in excess of 25 percent of the amount collected under a tax collection contract.[287]

Effective date.–The Senate amendment provision is effective on the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

8. Extension of customs user fees (sec. 358 of the Senate amendment)

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.

[287] 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.

House Bill

No provision.

Senate Amendment

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

Effective date.–The Senate amendment provision is effective on the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

9. Modify qualification rules for tax-exempt property and casualty insurance companies (sec. 359 of the Senate amendment and secs. 501 and 831 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 (whichever is greater) for the taxable year exceed $350,000, but do not exceed $1.2 million (sec. 831(b)).

For purposes of determining the amount of a 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).

House Bill

No provision.

Senate Amendment

The Senate amendment 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 Senate amendment 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 Senate amendment 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 a 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., any company that is not 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 so as to prevent improper use of the provision, including by characterizing as premiums income that is other than premium income.

Effective date.–The Senate amendment provision is effective for taxable years beginning after December 31, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

10. Authorize IRS to enter into installment agreements that provide for partial payment (sec. 360 of the Senate amendment 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.

House Bill

No provision.

Senate Amendment

The Senate amendment provision clarifies that the IRS is authorized to enter into installment agreements with taxpayers that do not provide for full payment of the taxpayer's liability over the life of the agreement. The Senate amendment 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 Senate amendment provision is effective for installment agreements entered into on or after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

11. Extend intangible amortization provisions to sports franchises (sec. 361 of the Senate amendment 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.[288] 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.[289] 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

[288] Sec. 197.

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

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.[290] 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.

House Bill

No provision.

Senate Amendment

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

Conference Agreement

The conference agreement does not include the Senate amendment provision.

12. Deposits made to suspend the running of interest on potential underpayments (sec. 362 of the Senate amendment 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

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

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.

House Bill

No provision.

Senate Amendment

In general

The Senate amendment 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 Senate amendment 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.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

13. Clarification of rules for payment of estimated tax for certain deemed asset sales (sec. 363 of the Senate amendment 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.

House Bill

No provision.

Senate Amendment

The Senate amendment 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 Senate amendment, 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 Senate amendment is effective for transactions that occur after the date of enactment of the provision.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

14. Limit deduction for charitable contributions of patents and similar property (sec. 364 of the Senate amendment 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.[291] 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

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

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.

House Bill

No provision.

Senate Amendment

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

Conference Agreement

The conference agreement does not include the Senate amendment provision.

15. Extension of provision permitting qualified transfers of excess pension assets to retiree health accounts (sec. 365 of the Senate amendment, 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.[292] 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[293] over the greater of (1) the plan's full funding limit[294] 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 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

---

[292] Sec. 420.

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

[294] A plan's full funding limit is the lesser of (1) for years beginning before January 1, 2004, the applicable percentage of current liability and (2) the plan's accrued liability. The applicable percentage of current liability is 170 percent for 2003. 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.

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 the 20-percent reversion 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 for a transfer to be qualified, the employer generally must maintain retiree health benefit costs 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.[295]

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

House Bill

No provision.

Senate Amendment

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

Effective date.–The Senate amendment provision is effective on the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

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

16. Proration rules for life insurance business of property and casualty insurance companies (sec. 366 of the Senate amendment and sec. 832 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."[296]

[296] 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).

House Bill

No provision.

Senate Amendment

The Senate amendment 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 Senate amendment 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).[297] 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 purposes of applying section 812(d), only the gross investment income attributable to the life insurance reserves 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 Senate amendment provision is effective for taxable years beginning after December 31, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

[297] 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 (b)(1)(B)).

17. Modify treatment of transfers to creditors in divisive reorganizations (sec. 367 of the Senate amendment and secs. 357 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.

House Bill

No provision.

Senate Amendment

The Senate amendment 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 Senate amendment 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 Senate amendment provision is effective for transactions on or after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

18. Taxation of minor children (sec. 368 of the Senate amendment and sec. 1 of the Code)

Present Law

Filing requirements for children

Single unmarried individuals eligible to be claimed as a dependent on another taxpayer's return generally must file an individual income tax return if he or she has (1) earned income only over $4,750 (for 2003), (2) unearned income only over the minimum standard deduction amount for dependents ($750 in 2003), or (3) both earned income and unearned income totaling more than the smaller of (a) $4,750 (for 2003) or (b) the larger of (i) $750 (for 2003), or (ii) earned income plus $250.[298] Thus, if a dependent child has less than $750 in gross income, the child does not have to file an individual income tax return for 2003.

A child who cannot be claimed as a dependent on another person's tax return (e.g., because the support test is not satisfied by any other person) is subject to the generally applicable filing requirements. That is, such an individual generally must file a return if the individual's gross income exceeds the sum of the standard deduction and the personal exemption amounts applicable to the individual.

Taxation of unearned income of minor children

Special rules apply to the unearned income of a child under age 14. These rules, generally referred to as the "kiddie tax," tax certain unearned income of a child at the parent's rate, regardless of whether the child can be claimed as a dependent on the parent's return.[299] The kiddie tax applies if: (1) the child has not reached the age of 14 by the close of the taxable year, (2) the child's investment income was more than $1,500 (for 2003) and (3) the child is required to file a return for the year. The kiddie tax applies regardless of the source of the property generating the income or when the property giving rise to the income was transferred to or otherwise acquired by the child. Thus, for example, the kiddie tax may apply to income from property acquired by the child with compensation derived from the child's personal services or from property given to the child by someone other than the child's parent.

The kiddie tax is calculated by computing the "allocable parental tax." This involves adding the net unearned income of the child to the parent's income and then applying the parent's tax rate. A child's "net unearned income" is the child's unearned income less the sum of (1) the minimum standard deduction allowed to dependents ($750 for 2003), and (2) the greater of (a) such minimum standard deduction amount or (b) the amount of allowable itemized

---

[298] Sec. 6012(a)(1)(C). Other filing requirements apply to dependents who are married, elderly, or blind. See, Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents,* at 3, Table 1 (2002).

[299] Sec. 1(g).

deductions that are directly connected with the production of the unearned income.[300] A child's net unearned income cannot exceed the child's taxable income.

The allocable parental tax equals the hypothetical increase in tax to the parent that results from adding the child's net unearned income to the parent's taxable income. If a parent has more than one child subject to the kiddie tax, the net unearned income of all children is combined, and a single kiddie tax is calculated. Each child is then allocated a proportionate share of the hypothetical increase.

If the parents file a joint return, the allocable parental tax is calculated using the income reported on the joint return. In the case of parents who are married but file separate returns, the allocable parental tax is calculated using the income of the parent with the greater amount of taxable income. In the case of unmarried parents, the child's custodial parent is the parent whose taxable income is taken into account in determining the child's liability. If the custodial parent has remarried, the stepparent is treated as the child's other parent. Thus, if the custodial parent and stepparent file a joint return, the kiddie tax is calculated using that joint return. If the custodial parent and stepparent file separate returns, the return of the one with the greater taxable income is used. If the parents are unmarried but lived together all year, the return of the parent with the greater taxable income is used. [301]

Unless the parent elects to include the child's income on the parent's return (as described below) the child files a separate return. In this case, items on the parent's return are not affected by the child's income. The total tax due from a child is the greater of:

(1) the sum of (a) the tax payable by the child on the child's earned income plus (b) the allocable parental tax or;

(2) the tax on the child's income without regard to the kiddie tax provisions.

Parental election to include child's unearned income

Under certain circumstances, a parent may elect to report a child's unearned income on the parent's return. If the election is made, the child is treated as having no income for the year and the child does not have to file a return. The requirements for the election are that:

(1) the child has gross income only from interest and dividends (including capital gains distributions and Alaska Permanent Fund Dividends);[302]

---

[300] Sec. 1(g)(4).

[301] Sec. 1(g)(5); Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents,* at 6 (2002).

[302] Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents,* at 7 (2002).

(2) such income is more than the minimum standard deduction amount for dependents ($750 in 2003) and less than 10 times that amount;

(3) no estimated tax payments for the year were made in the child's name and taxpayer identification number;

(4) no backup withholding occurred; and

(5) the child is required to file a return if the parent does not make the election.

Only the parent whose return must be used when calculating the kiddie tax may make the election. The parent includes in income the child's gross income in excess of twice the minimum standard deduction amount for dependents (i.e., the child's gross income in excess of $1,500 for 2003). This amount is taxed at the parent's rate. The parent also must report an additional tax liability equal to the lesser of: (1) $75 (in 2003), or (2) 10 percent of the child's gross income exceeding the child's standard deduction ($750 in 2003).

Including the child's income on the parent's return can affect the parent's deductions and credits that are based on adjusted gross income, as well as income-based phaseouts, limitations, and floors.[303] In addition, certain deductions that the child would have been entitled to take on his or her own return are lost.[304] Further, if the child received tax-exempt interest from a private activity bond, that item is considered a tax preference of the parent for alternative minimum tax purposes.[305]

Taxation of child's compensation for services

Compensation for a child's services, even though not retained by the child, is considered the gross income of the child, not the parent, even if the compensation is not received by the child (e.g. is the parent's income under local law).[306] If the child's income tax is not paid, however, an assessment against the child will be considered as also made against the parent to the extent the assessment is attributable to amounts received for the child's services.[307]

House Bill

No provision.

---

[303] Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents*, at 8 (2002).

[304] Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents*, at 7 (2002).

[305] Sec. 1(g)(7)(B).

[306] Sec. 73(a).

[307] Sec. 6201(c).

Senate Amendment

The Senate amendment provision increases the age of minors to which the kiddie tax provisions apply from under 14 to under 18.

Effective date.–The Senate amendment provision is effective for taxable years beginning after December 31, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

19. Provide consistent amortization period for intangibles (sec. 369 of the Senate amendment and secs. 195, 248, and 709 of the Code)

Present Law

At the election of the taxpayer, start-up expenditures[308] and organizational expenditures[309] may be amortized over a period of not less than 60 months, beginning with the month in which the trade or business begins. Start-up expenditures are amounts that would have been deductible as trade or business expenses, had they not been paid or incurred before business began. Organizational expenditures are expenditures that are incident to the creation of a corporation (sec. 248) or the organization of a partnership (sec. 709), are chargeable to capital, and that would be eligible for amortization had they been paid or incurred in connection with the organization of a corporation or partnership with a limited or ascertainable life.

Treasury regulations[310] require that a taxpayer file an election to amortize start-up expenditures no later than the due date for the taxable year in which the trade or business begins. The election must describe the trade or business, indicate the period of amortization (not less than 60 months), describe each start-up expenditure incurred, and indicate the month in which the trade or business began. Similar requirements apply to the election to amortize organizational expenditures. A revised statement may be filed to include start-up and organizational expenditures that were not included on the original statement, but a taxpayer may not include as a start-up expenditure any amount that was previously claimed as a deduction.

Section 197 requires most acquired intangible assets (such as goodwill, trademarks, franchises, and patents) that are held in connection with the conduct of a trade or business or an activity for the production of income to be amortized over 15 years beginning with the month in which the intangible was acquired.

---

[308] Sec. 195

[309] Secs. 248 and 709.

[310] Treas. Reg. sec. 1.195-1.

House Bill

No provision.

Senate Amendment

The Senate amendment modifies the treatment of start-up and organizational expeditures. A taxpayer would be allowed to elect to deduct up to $5,000 each of start-up and organizational expenditures in the taxable year in which the trade or business begins. However, each $5,000 amount is reduced (but not below zero) by the amount by which the cumulative cost of start-up or organizational expenditures exceeds $50,000, respectively. Start-up and organizational expenditures that are not deductible in the year in which the trade or business begins would be amortized over a 15-year period consistent with the amortization period for section 197 intangibles.

Effective date.–The Senate amendment provision is effective for start-up and organizational expenditures incurred after the date of enactment. Start-up and organizational expenditures that are incurred on or before the date of enactment would continue to be eligible to be amortized over a period not to exceed 60 months. However, all start-up and organizational expenditures related to a particular trade or business, whether incurred before or after the date of enactment, would be considered in determining whether the cumulative cost of start-up or organizational expenditures exceeds $50,000.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

20. Clarify definition of nonqualified preferred stock (sec. 370 of the Senate amendment and sec. 351 of the Code)

Present Law

The Taxpayer Relief Act of 1997 amended sections 351, 354, 355, 356, and 1036 to treat "nonqualified preferred stock" as boot in corporate transactions, subject to certain exceptions. For this purpose, preferred stock is defined as stock that is "limited and preferred as to dividends and does not participate in corporate growth to any significant extent." Nonqualified preferred stock is defined as any preferred stock if (1) the holder has the right to require the issuer or a related person to redeem or purchase the stock, (2) the issuer or a related person is required to redeem or purchase, (3) the issuer or a related person has the right to redeem or repurchase, and, as of the issue date, it is more likely than nor that such right will be exercised, or (4) the dividend rate varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or similar indices, regardless of whether such varying rate is provided as an express term of the stock (as in the case of an adjustable rate stock) or as a practical result of other aspects of the stock (as in the case of auction stock). For this purpose, clauses (1), (2), and (3) apply if the right or obligation may be exercised within 20 years of the issue date and is not subject to a contingency which, as of the issue date, makes remote the likelihood of the redemption or purchase.

House Bill

No provision.

Senate Amendment

The Senate amendment provision clarifies the definition of nonqualified preferred stock to ensure that stock for which there is not a real and meaningful likelihood of actually participating in the earnings and profits of the corporation is not considered to be outside the definition of stock that is limited and preferred as to dividends and does not participate in corporate growth to any significant extent.

As one example, instruments that are preferred on liquidation and that are entitled to the same dividends as may be declared on common stock do not escape being nonqualified preferred stock by reason of that right if the corporation does not in fact pay dividends either to its common or preferred stockholders. As another example, stock that entitles the holder to a dividend that is the greater of 7 percent or the dividends common shareholders receive does not avoid being preferred stock if the common shareholders are not expected to receive dividends greater than 7 percent.

No inference is intended as to the characterization of stock under present law that has terms providing for unlimited dividends or participation rights but, based on all the facts and circumstances, is limited and preferred as to dividends and does not participate in corporate growth to any significant extent.

Effective date.–The Senate amendment provision is effective for transactions after May 14, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

21. Establish specific class lives for utility grading costs (sec. 371 of the Senate amendment and sec. 168 of the Code)

Present Law

A taxpayer is allowed a depreciation deduction for the exhaustion, wear and tear, and obsolescence of property that is used in a trade or business or held for the production of income. For most tangible property placed in service after 1986, the amount of the depreciation deduction is determined under the modified accelerated cost recovery system (MACRS) using a statutorily prescribed depreciation method, recovery period, and placed in service convention. For some assets, the recovery period for the asset is provided in section 168. In other cases, the recovery period of an asset is determined by reference to its class life. The class lives of assets placed in

service after 1986 are generally set forth in Revenue Procedure 87-56.[311] If no class life is provided, the asset is allowed a 7-year recovery period under MACRS.

Assets that are used in the transmission and distribution of electricity for sale are included in asset class 49.14, with a class life of 30 years and a MACRS recovery period of 20 years. The cost of initially clearing and grading land improvements are specifically excluded from asset class 49.14. Prior to adoption of the accelerated cost recovery system, the IRS ruled that an average useful life of 84 years for the initial clearing and grading relating to electric transmission lines and 46 years for the initial clearing and grading relating to electric distribution lines, would be accepted. However, the result in this ruling was not incorporated in the asset classes included in Rev. Proc. 87-56 or its predecessors. Accordingly such costs are depreciated over a 7-year recovery period under MACRS as assets for which no class life is provided.

A similar situation exists with regard to gas utility trunk pipelines and related storage facilities. Such assets are included in asset class 49.24, with a class life of 22 years and a MACRS recovery period of 15 years. Initial clearing and grade improvements are specifically excluded from the asset class, and no separate asset class is provided for such costs. Accordingly, such costs are depreciated over a 7-year recovery period under MACRS as assets for which no class life is provided.

House Bill

No provision.

Senate Amendment

The Senate amendment assigns a class life to depreciable electric and gas utility clearing and grading costs incurred to locate transmission and distribution lines and pipelines. The provision includes these assets in the asset classes of the property to which the clearing and grading costs relate (generally, asset class 49.14 for electric utilities and asset class 49.24 for gas utilities, giving these assets a recovery period of 20 years and 15 years, respectively).

Effective date.–The Senate amendment provision is effective for electric and gas utility clearing and grading costs incurred after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

[311] 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

22. Prohibition on nonrecognition of gain through complete liquidation of holding company (sec. 372 of the Senate amendment and secs. 331 and 332 of the Code)

Present Law

A U.S. corporation owned by foreign persons is subject to U.S. income tax on its net income. In addition, the earnings of the U.S. corporation are subject to a second tax, when dividends are paid to the corporation's shareholders.

In general, dividends paid by a U.S. corporation to nonresident alien individuals and foreign corporations that are not effectively connected with a U.S. trade or business are subject to a U.S. withholding tax on the gross amount of such income at a rate of 30 percent. The 30-percent withholding tax may be reduced pursuant to an income tax treaty between the United States and the foreign country where the foreign person is resident.

In addition, the United States imposes a branch profits tax on U.S. earnings of a foreign corporation that are shifted out of a U.S. branch of the foreign corporation. The branch profits tax is comparable to the second-level taxes imposed on dividends paid by a U.S. corporation to foreign shareholders. The branch profits tax is 30 percent (subject to possible income tax treaty reduction) of a foreign corporation's dividend equivalent amount. The "dividend equivalent amount" generally is the earnings and profits of a U.S. branch of a foreign corporation attributable to its income effectively connected with a U.S. trade or business.

In general, U.S. withholding tax is not imposed with respect to a distribution of a U.S. corporation's earnings to a foreign corporation in complete liquidation of the subsidiary, because the distribution is treated as made in exchange for stock and not as a dividend. In addition, detailed rules apply for purposes of exempting foreign corporations from the branch profits tax for the year in which it completely terminates its U.S. business conducted in branch form. The exemption from the branch profits tax generally applies if, among other things, for three years after the termination of the U.S. branch, the foreign corporation has no income effectively connected with a U.S. trade or business, and the U.S. assets of the terminated branch are not used by the foreign corporation or a related corporation in a U.S. trade or business.

Regulations under section 367(e) provide that the Commissioner may require a domestic liquidating corporation to recognize gain on distributions in liquidation made to a foreign corporation if a principal purpose of the liquidation is the avoidance of U.S. tax. Avoidance of U.S. tax for this purpose includes, but is not limited to, the distribution of a liquidating corporation's earnings and profits with a principal purpose of avoiding U.S. tax.

House Bill

No provision.

Senate Amendment

The Senate amendment generally would treat as a dividend any distribution of earnings by a U.S. holding company to a foreign corporation in a complete liquidation, if the U.S. holding company was in existence for less than five years

Effective date.–The Senate amendment would be effective for liquidations and terminations occurring on or after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

23. Lease term to include certain service contracts (sec. 373 of the Senate amendment and sec. 168 of the Code)

Present Law

Under present law, "tax-exempt use property" must be depreciated on a straight-line basis over a recovery period equal to the longer of the property's class life or 125 percent of the lease term.[312] For purposes of this rule, "tax-exempt use property" is property that is leased (other than under a short-term lease) to a tax-exempt entity.[313] For this purpose, the term "tax-exempt entity" includes Federal, state and local governmental units, charities, and, foreign entities or persons.[314]

In determining the length of the lease term for purposes of the 125 percent calculation, a number of special rules apply. In addition to the stated term of the lease, the lease term includes: (1) any additional period of time in the realistic contemplation of the parties at the time the property is first put in service; (2) any additional period of time for which either the lessor or lessee has the option to renew the lease (whether or not it is expected that the option will be exercised); (3) any additional period of any successive leases which are part of the same transaction (or series of related transactions) with respect to the same or substantially similar property; and (4) any additional period of time (even if the lessee may not continue to be the lessee during that period), if the lessee (a) has agreed to make a payment in the nature of rent with respect to such period or (b) has assumed or retained any risk of loss with respect to such property for such period.

Tax-exempt use property does not include property that is used by a taxpayer to provide a service to a tax-exempt entity. So long as the relationship between the parties is a bona fide service contract, the taxpayer will be allowed to depreciate the property used in satisfying the contract under normal MACRS rules, rather than the rules applicable to tax-exempt use property.

House Bill

No provision.

---

[312] Sec. 168(g)(3)(A).

[313] Sec. 168(h)(1).

[314] Sec. 168(h)(2).

Senate Amendment

The Senate amendment requires lessors of tax-exempt use property to include the term of optional service contracts and other similar arrangements in the lease term for purposes of determining the recovery period.

Effective date.–The Senate amendment provision is effective for leases and other similar arrangements entered into after the date of enactment. No inference is intended with respect to the tax treatment of leases and other similar arrangements entered into before such date.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

24. Exclusion of like-kind exchange property from nonrecognition treatment on the sale or exchange of a principal residence (sec. 374 of the Senate amendment and sec. 121 of the Code)

Present Law

Under present law, a taxpayer may exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence.[315] To be eligible for the exclusion, the taxpayer must have owned and used the residence as a principal residence for at least two of the five years prior to the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or, to the extent provided under regulations, unforeseen circumstances is able to exclude an amount equal to the fraction of the $250,000 ($500,000 if married filing a joint return) that is equal to the fraction of the two years that the ownership and use requirements are met. There are no special rules relating to the sale or exchange of a principal residence that was acquired in a like-kind exchange within the prior five years.

House Bill

No provision.

Senate Amendment

The Senate amendment provides that the exclusion for gain on the sale or exchange of a principal residence does not apply if the principal residence was acquired in a like-kind exchange in which any gain was not recognized within the prior five years.

Effective date.–The Senate amendment provision is effective for sales or exchanges of principal residences after the date of enactment.

---

[315] Sec. 121.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

F. Other Provisions

1. Temporary State and local fiscal relief (sec. 381 of the Senate amendment)

Present Law

No provision.

House Bill

No provision.

Senate Amendment

The Senate amendment extends relief to States by establishing a temporary fund to provide $10 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, and $10 billion for Medicaid (FMAP).

Effective date.–The Senate amendment provision is effective on the date of enactment.

Conference Agreement

The conference agreement provides relief to States by establishing a temporary fund to provide $10 billion divided among the States to be used for essential government services, and $10 billion for Medicaid (FMAP). Nothing in this subsection shall be construed to preclude consideration of reforms to improve the Medicaid program.

Effective date.–The Senate amendment provision is effective on the date of enactment.

2. Review of State agency blindness and disability determinations (sec. 382 of the Senate amendment)

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.

House Bill

No provision.

Senate Amendment

The Senate amendment extends the initial review requirements for Title XVI SSI blindness and disability determinations with those currently required under Title II.

Effective date.–The Senate amendment provision is effective on effective on October 1, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

3. Prohibition on use of SCHIP funds to provide coverage for childless adults (sec. 383 of the Senate amendment)

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."[316]

House Bill

No provision.

Senate Amendment

The Senate amendment clarifies that SCHIP funds cannot be used for childless adults.

Effective date.–The Senate amendment provision is effective on the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

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

4. Increase Medicaid payments to states with extremely low disproportionate share hospitals (sec. 384 of the Senate amendment)

Present Law

Since 1981, States have been required to recognize, in establishing their Medicaid payment rates, the situation of hospitals that serve a disproportionate number of Medicaid beneficiaries and low-income patients. These hospitals are known as Disproportionate Share Hospitals ("DSH"). In State defined as extremely low DSH States, DSH payments are statutorily capped at one percent.

House Bill

No provision.

Senate Amendment

The Senate amendment increases the one percent cap on Medicaid payments to States defined as extremely low DSH States. The amendment increases that cap to three percent for fiscal year 2004. Twenty states benefit from this provision.

Effective date.–The Senate amendment provision is effective on the date of enactment for payments made in fiscal year 2004.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

VI. SMALL BUSINESS AND AGRICULTURAL PROVISIONS

A. Small Business Provisions

1. 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.[317] 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.

House Bill

No provision.

Senate Amendment

The Senate amendment 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.

---

[317] 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.

Effective date.–The Senate amendment provision applies to debt incurred after December 31, 2002, by a small business investment company described in the provision, with respect to property acquired by such company after such date.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

2. Repeal of occupational taxes relating to distilled spirits, wine, and beer (sec. 402 of the Senate amendment 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[318]:	
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

House Bill

No provision.

Senate Amendment

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

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

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

Conference Agreement

The conference agreement does not include the Senate amendment provision.

3. Custom gunsmiths (sec. 403 of the Senate amendment 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 (sec. 4182(a)). Sales of firearms, pistols, revolvers, shells and cartridges to the Department of Defense also are exempt from the tax (sec. 4182(b)).

House Bill

No provision.

Senate Amendment

The Senate amendment 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 in determining the 50-article limit.

Effective date.–The Senate amendment 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.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

4. Simplification of excise tax imposed on bows and arrows (sec. 404 of the Senate amendment 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)).

House Bill

No provision.

Senate Amendment

The Senate amendment increases the minimum draw weight for a taxable bow from 10 pounds to 30 pounds. The Senate amendment also imposes an excise tax of 12 percent on arrows generally. An arrow for this purpose is 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 provision. The Senate amendment provides that the 12-percent excise tax on arrows does not apply if the arrow contains an arrow shaft that was subject to the tax on arrow components. Finally, the Senate amendment 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 Senate amendment provision is effective on the date of enactment for articles sold by the manufacturer, producer, or importer.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

B. Agricultural Provisions

1. Capital gains treatment to apply to outright sales of timber by landowner (sec. 411 of the Senate Amendment and sec. 631 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)).

House Bill

No provision.

Senate Amendment

Under the Senate amendment, 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 Senate amendment provision is effective for sales of timber after the date of enactment.

Conference Agreement

The conference agreement does not contain the provision in the Senate amendment.

2. Special rules for livestock sold on account of weather-related conditions (sec. 412 of the Senate amendment 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.

House Bill

No provision.

Senate Amendment

The Senate amendment 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 Senate amendment 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.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

3. Exclusion from gross income for amounts paid under National Health Service Corps loan repayment program (sec. 413 of the of the Senate amendment 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.

House Bill

No provision.

Senate Amendment

The Senate amendment provision excludes from gross income loan repayments provided under the NHSC Loan Repayment Program.

Effective date.–The Senate amendment provision is effective with respect to amounts received by an individual in taxable years beginning after December 31, 2002.

Conference Agreement

The Conference agreement does not include the Senate amendment provision.

4. Payment of dividends on stock of cooperatives without reducing patronage dividends (sec. 414 of the Senate amendment 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").[319] 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.

House Bill

No provision.

Senate Amendment

The Senate amendment 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 Senate amendment provision is effective for distributions made in taxable years ending after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

[319] Treas. Reg. sec. 1.1388-1(a)(1).

VII. SIMPLIFICATION AND OTHER PROVISIONS

A. Establish Uniform Definition of a Qualifying Child (secs. 501 through 508 of the Senate amendment 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[320]

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.[321]

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

---

[320] 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.

[321] Sec. 151(d)(3).

Mexico;[322] and (5) did not file a joint return with his or her spouse for the year.[323] 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.[324] 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.[325] 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.[326] 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.

---

[322] 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).

[323] 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.

[324] Treas. Reg. sec. 1.152-1(b).

[325] *Id*.

[326] *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.[327]

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.[328] 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.[329] 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.[330]

---

[327] Rev. Rul. 66-28, 1966-1 C.B. 31.

[328] 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).

[329] 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).

[330] 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.[331] 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.[332] 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[333]

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;[334] (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.[335]

---

[331] 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).

[332] Sec. 151(c).

[333] Sec. 32.

[334] 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).

[335] 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.[336] 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.[337] 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[338]

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.[339] 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.[340] A portion of the child credit is refundable under certain circumstances.[341]

---

[336] 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).

[337] IRS Publication 596, *Earned Income Credit (EIC)*, at 13. H. Rep. 101-964 (October 27, 1990), at 1037.

[338] Sec. 24.

[339] 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).

[340] 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[342]

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,[343] 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.[344] 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[345]

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

---

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).

[341] Sec. 24(d).

[342] Sec. 21.

[343] 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.

[344] Sec. 21(e)(5).

[345] 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.[346] 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.

House Bill

No provision.

Senate Amendment

Description of provision

In general

The Senate amendment 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 head of household filing status. A taxpayer may claim an individual who does not meet the uniform definition of qualifying child (with respect to any taxpayer) as a dependent if the present-law dependency requirements are satisfied. The Senate amendment Senate amendment 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 Senate amendment provision, the present-law support and gross income tests for determining whether an individual is a dependent generally do not apply to a child who meets the requirements of the uniform definition of qualifying child.

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. It is intended 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.

[346] 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.

Relationship test

In order to be a qualifying child under the Senate amendment 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, is 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.[347]

Age test

Under the Senate amendment 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.[348] In general, no age limit applies with respect to individuals who are totally and permanently disabled within the meaning of section 22(e)(3) at any time during the calendar year. The Senate amendment 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 Senate amendment provision, a child who provides over one half of his or her own support generally is not considered a qualifying child of another taxpayer. The Senate amendment provision retains the present-law rule, however, that a child who provides over one half of his or her own support may constitute a qualifying child of another taxpayer for purposes of the earned income credit.

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

---

[347] 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.

[348] The provision retains the present-law definition of full-time student set forth in section 151(c)(4).

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 claim an individual who does not meet the uniform definition of qualifying child with respect to any taxpayer as a dependent if the present-law dependency requirements (including the gross income and support tests) are satisfied.[349] 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 Senate amendment 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 Senate amendment 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 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 Senate amendment 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

The Senate amendment provision retains the applicable present-law requirements that a taxpayer identification number for a child be 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).

[349] Individuals who satisfy the present-law dependency tests and who are not qualifying children are referred to as "qualifying relatives" under the provision.

Effect of Senate amendment provision on particular tax benefits

Dependency exemption

For purposes of the dependency exemption, the Senate amendment 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 under the Senate amendment 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 the qualifying child.

The Senate amendment 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 Senate amendment 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 Senate amendment 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 and certain other children 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 Senate amendment 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 present-law requirement that a foster child and certain other children be cared for as the taxpayer's own child is eliminated. The age limitation under the Senate amendment 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 an individual who is physically or mentally incapable of caring for himself or herself are amended to include a requirement that the taxpayer and the dependent have the same principal place of abode for more than one half the taxable year.

Head of household filing status

Under the Senate amendment provision, a taxpayer qualifies for head of household filing status with respect to a child who is a qualifying child as defined under the Senate amendment 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 Senate amendment 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 Senate amendment provision retains the present-law requirement that the taxpayer provide over one half the cost of maintaining the household.

Effective date

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

Conference Agreement

The conference agreement does not include the Senate amendment provision.

B. Other Simplification Provisions

1. Consolidation of life insurance and nonlife companies (sec. 511 of the Senate amendment and sec. 1504 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.

House Bill

No provision.

Senate Amendment

The Senate amendment 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 (sec. 1504(c)(1)). 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 section 1503(c)(1) with respect to any life insurance company that is an includible corporation of an affiliated group.

Effective date.–The Senate amendment provision is effective for taxable years beginning after December 31, 2009. No affiliated group terminates solely by reason of the provision. Under regulations, 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 solely 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).

Conference Agreement

The conference agreement does not include the Senate amendment provision.

2. Suspension of reduction of deductions for mutual life insurance companies and of policyholder surplus accounts of life insurance companies (sec. 512 of the Senate amendment and secs. 809 and 815 of the Code)

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.

For a mutual life insurance company's taxable years beginning in 2001, 2002, or 2003, the differential earnings rate is treated as zero for purposes of computing both the differential earnings amount and the recomputed differential earnings amount (true-up).

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 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.

House Bill

No provision.

Senate Amendment

Reduction in deductions for policyholder dividends and reserves of mutual life insurance companies (sec. 809)

The Senate amendment provision provides that for a mutual life insurance company's taxable years beginning after December 31, 2003, and before January 1, 2009, the differential earnings rate is treated as zero for purposes of computing both the differential earnings amount and the recomputed differential earnings amount (true-up), 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 Senate amendment 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 Senate amendment provision also modifies the order in which distributions reduce the various accounts, so that distributions are 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 Senate amendment provisions relating to section 809 and section 815 are effective for taxable years beginning after December 31, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provisions.

3. Section 355 "active business test" applied to chains of affiliated corporations (sec. 513 of the Senate amendment 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.[350] 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.[351]

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.[352] 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.[353]

House Bill

No provision.

Senate Amendment

Under the Senate amendment, 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 Senate amendment applies to distributions after the date of enactment, with three exceptions. The Senate amendment 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

---

[350] 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.

[351] Section 355(b)(2)(A).

[352] Rev. Proc. 2003-3, sec. 4.01(30), 2003-1 I.R.B. 113.

[353] 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.

filing with the Securities and Exchange Commission. The distributing corporation may irrevocably elect not to have the exceptions described above apply.

The Senate amendment 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).[354]

Conference Agreement

The conference agreement does not include the Senate amendment provision.

[354] 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).

C. Other Provisions

1. Civil rights tax relief (sec. 521 of the Senate amendment and sec. 62 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.[355] Expenses relating to recovering such damages are generally not deductible.[356]

Other damages are generally included in gross income. The related expenses to recover the damages, including attorneys' fees, are generally deductible as expenses for the production of income,[357] subject to the two-percent floor on itemized deductions.[358] Thus, such expenses are deductible only to the extent the taxpayer's total miscellaneous itemized deductions exceed two percent of adjusted gross income. 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.[359] For purposes of the alternative minimum tax, no deduction is allowed for any miscellaneous itemized deduction.

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[360] 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 and to the overall limitation on itemized deductions. Other courts have held that the portion of the recovery that is

---

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

[356] Sec. 265(a)(1).

[357] Sec. 212.

[358] Sec. 67.

[359] Sec. 68.

[360] *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).

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.[361]

House Bill

No provision.

Senate Amendment

The Senate amendment provides an above-the-line deduction for attorneys' fees and costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful discrimination or certain claims against the Federal Government. The amount that may be deducted above-the-line may not exceed the amount includible in the taxpayer's gross income for the taxable year on account of a judgment or settlement (whether by suit or agreement and whether as lump sum or periodic payments) resulting from such claim.

Under the Senate amendment, "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, any provision of Federal law (popularly known as whistleblower protection provisions) 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 Senate amendment is effective for fees and costs paid after the date of enactment with respect to any judgment or settlement occurring after such date.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

---

[361] *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.

2. Increase section 382 limitation for certain corporations in bankruptcy (sec. 522 of the Senate amendment 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.

In general, an ownership change occurs if, within a three-year period, there is a 50-percentage point 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.

House Bill

No provision.

Senate Amendment

For a limited time period, the Senate amendment 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 Senate amendment 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 Senate amendment provision is effective for taxable years beginning in 2004 and 2005.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

3. Increase in historic rehabilitation credit for residential housing for the elderly (sec. 523 of the Senate amendment 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").

House Bill

No provision.

Senate Amendment

The Senate amendment 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 Senate amendment 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.[362]

Effective date.–The Senate amendment provision is effective for property placed in service after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

4. Modification of application of income forecast method of depreciation (sec. 524 of the Senate amendment 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.

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

---

[362] The Senate amendment 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.

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.

House Bill

No provision.

Senate Amendment

The Senate amendment 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)). 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 Senate amendment 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 Senate amendment 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 Senate amendment 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 Senate amendment 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 Senate amendment 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.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

5. Additional advance refunding of certain governmental bonds (sec. 525 of the Senate amendment 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 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.

House Bill

No provision.

Senate Amendment

Under the Senate amendment, 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 Senate amendment provision is effective for advance refunding bonds issued after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

6. Exclusion of income derived from certain wagers on horse races from gross income of nonresident alien individuals (sec. 526 of the Senate amendment 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[363] event taking place within the United States, the

[363] 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

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.

House Bill

No provision.

Senate Amendment

The Senate amendment 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-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 Senate amendment provision applies to proceeds from wagering transactions after September 30, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

---

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.

7. Federal reimbursement of emergency health services furnished to undocumented aliens (sec. 527 of the Senate amendment)

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.

House Bill

No provision.

Senate Amendment

The Senate amendment provides an entitlement of $48 million for fiscal year 2004 for the Federal reimbursement for providers of emergency health services to undocumented aliens.

Effective date.–The Senate amendment provision is effective beginning in fiscal year 2004.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

8. Treatment of premiums for mortgage insurance (sec. 528 of the Senate amendment and sec. 163 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.

House Bill

No provision.

Senate Amendment

The Senate amendment 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).

Amounts paid for qualified mortgage insurance that are properly allocable to periods after the close of the taxable year are treated as paid in the period to which it is 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 Senate amendment provision is effective for amounts paid or accrued after the date of enactment in taxable years ending after that date.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

9. Sense of the Senate on repealing the 1993 tax hike on Social Security Benefits (sec. 529 of the Senate Amendment)

Present Law

Present law provides for a two-tier system of taxation of Social Security benefits. Under this system, up to either 50 percent or 85 percent of Social Security benefits and includible in gross income, depending on the taxpayer’s income. The 85-percent tax was enacted in 1993.

House Bill

No provision.

Senate Amendment

The Senate amendment includes a sense of the Senate that the Senate Finance Committee should report out the Social Security Benefits Tax Relief Act of 2003[364] to repeal the tax on seniors not later than July 31, 2003, and that the Senate will consider such bill not later than September 30, 2003, in a manner consistent with the preservation of the Medicare Trust Fund.

Effective date.--The Senate amendment is effective on the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

10. Sense of the Senate relating to the flat tax (sec. 530 of the Senate amendment)

Present Law

No provision.

House Bill

No provision.

Senate Amendment

The Senate amendment includes a sense of the Senate that the Senate Finance Committee and the Joint Economic Committee should undertake a comprehensive analysis of simplification or flat tax proposals, including appropriate hearings, and consider legislation providing for a flat tax.

Effective date.-- The provision is effective on the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

11. Temporary rate reduction for certain dividends received from controlled foreign corporations (sec. 531 of the Senate amendment and new sec. 965 of the Code)

Present Law

The United States employs a "worldwide" tax system, under which domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Income earned by a domestic parent corporation from foreign operations conducted by 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.

---

[364] S. 514.

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[365] and the passive foreign investment company rules.[366] 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.[367]

House Bill

No provision.

Senate Amendment

Under the Senate amendment, certain actual and deemed dividends received by a U.S. corporation from a controlled foreign corporation are subject to tax at a reduced rate of 5.25 percent. For corporations taxed at the top corporate income tax rate of 35 percent, this rate reduction is equivalent to an 85-percent dividends-received deduction. This rate reduction is available only for the first taxable year of an electing taxpayer ending 120 days or more after the date of enactment of the provision.

The reduced rate applies only to repatriations in excess of the taxpayer's average repatriation level over 3 of the 5 most recent taxable years ending on or before December 31, 2002, determined by disregarding the highest-repatriation year and the lowest-repatriation year among such 5 years.[368] The taxpayer may designate which of its dividends are treated as meeting the base-period average level and which of its dividends are treated as comprising the excess.

In order to qualify for the reduced rate, dividends must be described in a "domestic reinvestment plan" approved by the taxpayer's senior management and board of directors. This plan must provide for the reinvestment of the repatriated dividends in the United States, "including as a source for the funding of worker hiring and training; infrastructure; research and development; capital investments; or the financial stabilization of the corporation for the purposes of job retention or creation."

---

[365] Secs. 951-964.

[366] Secs. 1291-1298.

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

[368] If the taxpayer has fewer than 5 taxable years ending on or before December 31, 2002, then the base period consists of all such taxable years, with none disregarded.

The Senate amendment provision disallows 85 percent of the foreign tax credits attributable to dividends subject to the reduced rate and removes 85 percent of the underlying income from the taxpayer's foreign tax credit limitation fraction under section 904.

In the case of an affiliated group, an election under the provision is made by the common parent on a group-wide basis, and all members of the group are treated as a single taxpayer. The election applies to all controlled foreign corporations with respect to which an electing taxpayer is a United States shareholder.

Effective date.–The Senate amendment provision is effective for the first taxable year of an electing taxpayer ending 120 days or more after the provision's date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

12. Repeal of 10-percent rehabilitation tax credit (sec. 531 of the Senate amendment and section 47 of the Code)

Present Law

Present law provides a two-tier tax 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 10-percent credit is provided for rehabilitation expenditures with respect to buildings first placed in service before 1936. The pre-1936 building must meet certain requirements in order for expenditures with respect to it to qualify for the rehabilitation tax credit. In the rehabilitation process, certain walls and structures must have been retained. Specifically, (1) 50 percent or more of the existing external walls must be retained in place as external walls, (2) 75 percent or more of the existing external walls of the building must be retained in place as internal or external walls, and (3) 75 percent or more of the existing internal structural framework of the building must be retained in place. Further, the building must have been substantially rehabilitated, and it must have been placed in service before the beginning of the rehabilitation. 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 with or within the taxable year exceed the greater of (1) the adjusted basis of the building (and its structural components), or $5,000.

House Bill

No provision.

Senate Amendment

The Senate amendment provision repeals the 10-percent credit for rehabilitation expenditures with respect to buildings first placed in service before 1936. The provision retains the present-law 20-percent credit for rehabilitation expenditures with respect to a certified historic structure.

Effective date.--The provision is effective for expenditures incurred after December 31, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

13. Income inclusion for certain delinquent child support (sec. 532 of the Senate amendment and sec. 166 of the Code)

Present Law

Bad debt deduction

Non-business bad debts may be deductible as short-term capital losses on Schedule D of the Form 1040. Non-business bad debts generally are debts that the taxpayer did not acquire or create in the course of operating the taxpayer's business. The present-law rule that capital losses (both short-term and long-term) may not exceed the sum of $3,000 plus any capital gains for any taxable year is applicable.

Non-business bad debts are only deductible only if: (1) the debt is wholly worthless (partially worthless debts are not deductible) and (2) the taxpayer has a tax basis in the debt that becomes bad. If these requirements are satisfied, the amount of the deductible non-business bad debt is the individual's basis in the bad debt. Generally, the amount of basis that a taxpayer has in a debt is the amount of the cash advance in the case of a loan or the amount of taxable income recognized by the taxpayer with reference to the debt. Deductions for bad debts are allowed only for the taxable year in which the debt becomes wholly worthless.

Custodial parents do not qualify for a non-business bad debt deduction on unpaid child support because, they have no basis in the debt and the debt may not be wholly worthless.

Bad debt income inclusion

There is no income inclusion for individuals who are delinquent in paying their child support obligations.

House Bill

No provision

Senate Amendment

The Senate amendment creates an income inclusion for a non-custodial parent for certain unpaid child support obligations at the close of a taxable year. The income inclusion is limited to the amount of unpaid child support at the end of the taxable year that equals or exceeds one-half of the non-custodial taxpayer's total child support obligation to the custodial parent for the year. This test is not applied on a child-by-child basis. For example, in the case of child support for two children, the test applies the one-half or more test to the combined child support obligations for both children.

Under the bill, any payments from the non-custodial parent to the custodial parent subsequent to the close of the taxable year are not deductible by the non-custodial parent (regardless of whether the non-custodial parent had a previous income inclusion with regard to such amounts).

Effective date.–The Senate amendment provision is effective for taxable years beginning after December 31, 2002.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

14. Sense of the Senate regarding the low-income housing tax credit (sec. 533 of the Senate amendment)

Present Law

The low-income housing tax credit 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 qualified expenditures.

The aggregate credit authority provided annually to each State was $1.75 per resident in calendar year 2002. Beginning in calendar year 2003, the per-capita portion of the credit cap will be adjusted annually for inflation. For small States, a minimum annual cap of $2 million was provided for calendar year 2002. Beginning in calendar year 2003, the small State minimum is adjusted for inflation.

House Bill

No provision.

Senate Amendment

The Senate amendment includes a statement that it is the sense of the Senate that any reduction or elimination of the taxation on dividends should include provisions to preserve the success of the low-income housing tax credit.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

15. Expensing of investment in broadband equipment (sec. 534 of the Senate amendment and new sec. 191 of the Code)

Present Law

Under present law, a taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the Modified Accelerated Cost Recovery System (MACRS) of section 168, which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property.

Personal property is classified under MACRS based on the property's "class life" unless a different classification is specifically provided in section 168. The class life applicable for personal property is the asset guideline period (midpoint class life as of January 1, 1986). Based on the property's classification, a recovery period is prescribed under MACRS. In general, there are six classes of recovery periods to which personal property can be assigned. For example, personal property that has a class life of four years or less has a recovery period of three years, whereas personal property with a class life greater than four years but less than 10 years has a recovery period of five years. The class lives and recovery periods for most property are contained in Rev. Proc. 87-56, 1987-2 CB 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 CB 785).

House Bill

No provision.

Senate Amendment

The Senate amendment provides that expenses incurred by the taxpayer for qualified broadband expenditures with respect to qualified equipment placed in service prior to January 1, 2005 may be deducted in full in the year in which the equipment is placed in service.

Qualified expenditures are expenditures incurred with respect to equipment with which the taxpayer offers current generation broadband services to qualified subscribers. In addition, qualified expenditures include qualified expenditures incurred by the taxpayer with respect to qualified equipment with which the taxpayer offers next generation broadband services to qualified subscribers. Current generation broadband services are defined as the transmission of

signals at a rate of at least 1 million bits per second to the subscriber and at a rate of at least 128,000 bits per second from the subscriber. Next generation broadband services are defined as the transmission of signals at a rate of at least 22 million bits per second to the subscriber and at a rate of at least 5 million bits per second from the subscriber.

Qualified subscribers for the purposes of the current generation broadband deduction include nonresidential subscribers in rural or underserved areas, and residential subscribers in rural or underserved areas that are not in a saturated market. A saturated market is defined as a census tract in which current generation broadband services have been provided by a single provider to 85 percent or more of the total number of potential residential subscribers residing within such census tracts. For the purposes of the next generation broadband deduction, qualified subscribers include nonresidential subscribers in rural or underserved areas or any residential subscriber. In the case of a taxpayer who incurs expenditures for equipment capable of serving both subscribers in qualifying areas and other areas, qualifying expenditures are determined by multiplying otherwise qualifying expenditures by the ratio of the number of potential qualifying subscribers to all potential subscribers the qualifying equipment would be capable of serving.

Qualifying equipment must be capable of providing broadband services a majority of the time during periods of maximum demand. Qualifying equipment is that equipment that extends from the last point of switching to the outside of the building in which the subscriber is located, equipment that extends from the customer side of a mobile telephone switching office to a transmission/reception antenna (including the antenna) of the subscriber, equipment that extends from the customer side of the headend to the outside of the building in which the subscriber is located, or equipment that extends from a transmission/reception antenna to a transmission/reception antenna on the outside of the building used by the subscriber. Any packet switching equipment deployed in connection with other qualifying equipment is qualifying equipment, regardless of location, provided that it is the last such equipment in a series as part of transmission of a signal to a subscriber or the first in a series in the transmission of a signal from a subscriber. Also, multiplexing and demultiplexing equipment also is qualified equipment.

A rural area is any census tract which is not within 10 miles of any incorporated or census designated place with a population of more than 25,000 and which is not within a county with a population density of more than 500 people per square mile. An underserved area is any census tract which is located in an empowerment zone or enterprise community or any census tract in which the poverty level is greater than or equal to 30 percent and in which the median family income is less than 70 percent of the greater of metropolitan area median family income or Statewide median family income. A residential subscriber is any individual who purchases broadband service to be delivered to his or her dwelling.

Effective date.–The Senate amendment provision is effective for property placed in service after December 31, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

16. Income tax credit for cost of carrying tax-paid distilled spirits in wholesale inventories and in control State bailment warehouses (sec. 535 of the Senate amendment and new sec. 5011 of the Code)

Present Law

As is true of most major Federal excise taxes, the excise tax on distilled spirits is imposed at a point in the chain of distribution before the product reaches the retail (consumer) level. Tax on domestically produced and/or bottled distilled spirits arises upon production (receipt) in a bonded distillery and is collected based on removals from the distillery during each semi-monthly period. Distilled spirits that are bottled before importation into the United States are taxed on removal from the first U.S. warehouse where they are landed (including a warehouse located in a foreign trade zone).

No tax credits are allowed under present law for business costs associated with having tax-paid products in inventory. Rather, excise tax that is included in the purchase price of a product is treated the same as the other components of the product cost, i.e., deductible as a cost of goods sold.

House Bill

No provision.

Senate Amendment

The Senate amendment creates a new income tax credit for wholesale distributors, distillers, and importers, of distilled spirits. The credit is calculated by multiplying the number of cases of bottled distilled spirits by the average tax-financing cost per case for the most recent calendar year ending before the beginning of such taxable year. A case is 12 80-proof 750-milliliter bottles. The average tax-financing cost per case is the amount of interest that would accrue at corporate overpayment rates during an assumed 60-day holding period on an assumed tax rate of $25.68 per case of 12 750-milliliter bottles.

The wholesaler credit only applies to domestically bottled distilled spirits[369] purchased directly from the bottler of such spirits. For distillers and importers, the credit is limited to bottled inventory in a warehouse owned and operated by, or on behalf of, a State when title to such inventory has not passed unconditionally. The credit for distillers and importers applies to distilled spirits bottled both domestically and abroad.

The credit is in addition to present-law rules allowing tax included in inventory costs to be deducted as a cost of goods sold.

The credit cannot be carried back to a taxable year beginning before January 1, 2003.

---

[369] Distilled spirits that are imported in bulk and then bottled domestically qualify as domestically bottled distilled spirits.

Effective date.–The Senate amendment provision is effective for taxable years beginning after December 31, 2002.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

17. Contribution in aid of construction (sec. 536 of the Senate amendment and sec. 118 of the Code)

Present Law

Section 118(a) provides that gross income of a corporation does not include a contribution to its capital. In general, section 118(b) provides that a contribution to the capital of a corporation does not include any contribution in aid of construction or any other contribution as a customer or potential customer and, as such, is includible in gross income of the corporation. However, for any amount of money or property received by a regulated public utility that provides water or sewerage disposal services, such amount shall be considered a contribution to capital (excludible from gross income) so long as such amount: (1) is a contribution in aid of construction, and (2) is not included in the taxpayer's rate base for rate-making purposes. If the contribution is in property other than water or sewerage disposal facilities, the amount is generally excludible from gross income only if the amount is expended to acquire or construct water or sewerage disposal facilities within a specified time period. A contribution in aid of construction does not include a customer connection fee or amounts paid as service charges for starting or stopping services.

House Bill

No provision.

Senate Amendment

The Senate amendment clarifies that water and sewer service laterals received by a regulated public utility that provides water or sewerage disposal services is considered a contribution to capital and excludible from gross income of such utility.

Effective date.–The Senate amendment provision is effective for contributions made after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

18. Travel expenses for spouses (sec. 537 of the Senate amendment and sec. 274 of the Code)

Present Law

In general, no deduction is permitted for the travel expenses of a spouse, dependent, or other individual accompanying a taxpayer (or an officer or employee of the taxpayer) on business travel.[370]

House Bill

No provision.

Senate Amendment

The Senate amendment repeals this provision generally prohibiting a deduction for the travel expenses of a spouse, dependent, or other person accompanying a taxpayer (or an officer or employee of a taxpayer). All other present-law limitations on these expenses continue to apply.

Effective date.–The Senate amendment provision is effective for expenses paid or incurred after the date of enactment and on or before December 31, 2004.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

19. Certain sightseeing flights exempt from taxes on air transportation (sec. 538 of the Senate amendment and sec. 4281 of the Code)

Present Law

The Code imposes a tax on amounts paid for the taxable transportation of persons ("the ticket tax") (sec. 4261(a)). Taxable transportation for purposes of imposing the ticket tax is transportation that begins and ends in the United States (sec. 4262(a)). Aircrafts having a maximum certificated takeoff weight of 6,000 pounds or less ("small aircraft") are not subject to the ticket tax unless such aircraft is operated on an established line (sec. 4281).

Treasury regulations define the term "operated on an established line" to mean operated with some degree of regularity between definite points (Treas. Reg. sec. 49.4263-5(c)). The term implies that the air carrier maintains control over the direction, routes, time, number of passengers carried, etc. The Treasury regulations also provide that transportation need not be between two definite points to be taxable. A payment for continuous transportation beginning and ending at the same point is subject to the tax (Treas. Reg. sec. 49.4261-1(c)). Thus, the

[370] Sec. 274(m)(3).

ticket tax applies to regularly conducted sightseeing air tours that begin and end at the same point.[371]

House Bill

No provision.

Senate Amendment

Under the Senate amendment, small aircrafts are not considered as operated on an established line if such aircraft is operated on a flight the sole purpose of which is sightseeing.

Effective date.–The Senate amendment provision is effective with respect to transportation beginning on or after the date of enactment, but does not apply to any amount paid before such date.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

20. Required coverage for reconstructive surgery following mastectomies (sec. 539 of the Senate amendment and new sec. 9813 of the Code)

Present Law

The Women's Health and Cancer Rights Act of 1998 amended ERISA and the Public Health Service Act to provide that health plans offering mastectomy coverage must also provide coverage for reconstructive breast surgery. Under ERISA, a group health plan, and a health insurance issuer providing health insurance coverage in connection with a group health plan, that provides medical and surgical benefits with respect to mastectomies is required to provide coverage for reconstructive surgery following mastectomies.[372] In the case of a participant or beneficiary who is receiving benefits in connection with a mastectomy and who elects breast reconstruction in connection with such mastectomy, coverage is required for (1) all stages of reconstruction of the breast on which the mastectomy has been performed, (2) surgery and

---

[371] *See Lake Mead Air Inc. v. United States*, 99-1 USTC par. 70,119 (D. Nev. 1997). The *Lake Mead* court found that that the tours started and ended at the same point without fail therefore, the flights were between definite points. Finding that the flights were operated with some degree of regularity and between definite points, the court found that the flights were operated on an established line. As a result, the exemption for small aircraft operating on nonestablished lines did not apply and the court concluded that the flights were taxable transportation for purposes of the ticket tax. However, the court found that Lake Mead was not a responsible person for collecting the tax for purposes of the 100 percent penalty imposed by section 6672.

[372] ERISA sec. 713. A similar provision is also included in the Public Health Service Act.

reconstruction of the other breast to produce a symmetrical appearance, and (3) prostheses and physical complications of mastectomy, including lymphedemas, in a manner determined in consultation with the attending physician and the patient.

Coverage may be subject to annual deductibles and coinsurance provisions as may be deemed appropriate and as are consistent with those established for other benefits under the plan or coverage. Written notice of the availability of the coverage must be delivered to the participant upon enrollment and annually thereafter. Notice must be in writing and prominently positioned in any literature or correspondence made available or distributed by the plan or issuer and must be transmitted as specifically required.

A group health plan may not deny a patient eligibility, or continued eligibility, to enroll or to renew coverage under the terms of the plan, solely for the purpose of avoiding the requirements of the provision. In addition, a group health plan may not penalize or otherwise reduce or limit the reimbursement of an attending provider, or provide incentives (monetary or otherwise) to an attending provider, to induce such provider to provide care to an individual participant or beneficiary in a manner inconsistent with the provision. Nothing in the section should be construed to prevent a group health plan from negotiating the level and type of reimbursement with a provider for care provided in accordance with the section.

The Code imposes an excise tax on failures to meet certain group health plan requirements.[373] The excise tax is equal to $100 per day during the period of noncompliance and is generally imposed on the employer sponsoring the plan if the plan fails to meet the requirements. The maximum tax that can be imposed during a taxable year cannot exceed the lesser of 10 percent of the employer's group health plan expenses for the prior year or $500,000. No tax is imposed if the Secretary determines that the employer did not know, and exercising reasonable diligence would not have known, that the failure existed.

Present law does not impose an excise tax relating to required coverage for reconstructive surgery following mastectomies.

House Bill

No provision.

Senate Amendment

The Senate amendment adds to the Code a provision requiring a group health plan that provides medical and surgical benefits with respect to a mastectomy to provide coverage for reconstructive surgery following the mastectomy. The requirements follow those of ERISA. A group health plan that does not comply with the requirements of the provision is subject to the excise tax on failures to meet certain group health plan requirements.[374]

---

[373] Sec. 4980D.

[374] Sec. 4980D.

Under the new Code section, a group health plan that provides medical and surgical benefits with respect to a mastectomy must provide, in the case of a participant or beneficiary who is receiving benefits in connection with a mastectomy and who elects breast reconstruction in connection with such mastectomy, coverage for (1) all stages of reconstruction of the breast of which the mastectomy has been performed, (2) surgery and reconstruction of the other breast to produce a symmetrical appearance, and (3) prostheses and physical complications of mastectomy, including lymphedemas, in a manner determined in consultation with the attending physician and the patient.

Coverage may be subject to annual deductibles and coinsurance provisions as deemed appropriate and consistent with those established for other benefits under the plan. Written notification of the availability of such coverage must be delivered to the participant upon enrollment and annually thereafter. Unlike ERISA, the specific manner in which notice must be given is not included in the new Code provision.

Under the Senate amendment, a group health plan may not deny a patient eligibility, or continued eligibility, to enroll or to renew coverage under the terms of the plan, solely for the purpose of avoiding the requirements of the provision. In addition, a group health plan may not penalize or otherwise reduce or limit the reimbursement of an attending provider, or provide incentives (monetary or otherwise) to an attending provider, to induce such provider to provide care to an individual participant or beneficiary in a manner inconsistent with the provision. Nothing in the provision should be construed to prevent a group health plan from negotiating the level and type of reimbursement with a provider for care provided in accordance with the provision.

Under the Senate amendment, in the case of a group heath plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers, any plan amendment made pursuant to a collective bargaining agreement relating to the plan which amends the plan solely to conform to any requirement added by the provision will not be treated as a termination of the collective bargaining agreement.

Effective date.–The Senate amendment provision is effective for plan years beginning on or after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

21. Renewal community modifications (secs. 540 and 541 of the Senate amendment and secs. 1400E and 1400H of the Code)

Present Law

The Code authorizes the designation of 40 "renewal communities" within which special tax incentives will be available. The following is a description of the designation process and the tax incentives that will be available within the renewal communities.

Designation process

Designation of 40 renewal communities.–The Secretary of HUD, was authorized to designate up to 40 renewal communities from areas nominated by States and local governments. At least 12 of the designated communities must be in rural areas. The designation of an area as a renewal community terminates after December 31, 2009.

Eligibility criteria.–To be designated as a renewal community, a nominated area must meet the following criteria: (1) each census tract must have a poverty rate of at least 20 percent; (2) in the case of an urban area, at least 70 percent of the households have incomes below 80 percent of the median income of households within the local government jurisdiction; (3) the unemployment rate is at least 1.5 times the national unemployment rate; and (4) the area is one of pervasive poverty, unemployment, and general distress. Generally, those areas with the highest average ranking of eligibility factors (1), (2), and (3) above will be designated as renewal communities.

The boundary of a renewal community must be continuous. In addition, the renewal community must have a minimum population of 4,000 if the community is located within a metropolitan statistical area (at least 1,000 in all other cases), and a maximum population of not more than 200,000. The population limitations do not apply to any renewal community that is entirely within an Indian reservation.

In addition, certain State and local government commitments are necessary for an area to receive designation.

Tax incentives for renewal communities

The following tax incentives generally are available during the period beginning January 1, 2002, and ending December 31, 2009.

Zero-percent capital gain rate.–A zero-percent capital gains rate applies with respect to gain from the sale of a qualified community asset acquired after December 31, 2001, and before January 1, 2010, and held for more than five years. A "qualified community asset" includes: (1) qualified community stock (meaning original-issue stock purchased for cash in a renewal community business); (2) a qualified community partnership interest (meaning a partnership interest acquired for cash in a renewal community business); and (3) qualified community business property (meaning tangible property originally used in a renewal community business by the taxpayer) that is purchased or substantially improved after December 31, 2001.

The termination of an area's status as a renewal community will not affect whether property is a qualified community asset, but any gain attributable to the period before January 1, 2002, or after December 31, 2014, is not eligible for the zero-percent rate.

Renewal community employment credit.–A 15-percent wage credit is available to employers for the first $10,000 of qualified wages paid to each employee who (1) is a resident of the renewal community, and (2) performs substantially all employment services within the renewal community in a trade or business of the employer. In general, any taxable business carrying out activities in the renewal community may claim the wage credit.

Commercial revitalization deduction.–Each State is permitted to allocate up to $12 million of "commercial revitalization expenditures" to each renewal community located within the State for each calendar year after 2001 and before 2010. The appropriate State agency will make the allocations pursuant to a qualified allocation plan. A "commercial revitalization expenditure" means the cost of a new building or the cost of substantially rehabilitating an existing building. The qualifying expenditures for any building cannot exceed $10 million.

Additional section 179 expensing.–A renewal community business is allowed an additional $35,000 of section 179 expensing for qualified renewal property placed in service after December 31, 2001, and before January 1, 2010. The section 179 expensing allowed to a taxpayer is phased out by the amount by which 50 percent of the cost of qualified renewal property placed in service during the year by the taxpayer exceeds $200,000.

Extension of work opportunity tax credit ("WOTC").–The provision expands the high-risk youth and qualified summer youth categories in the WOTC to include qualified individuals who live in a renewal community.

Expiration date

The tax benefits available in renewal communities are effective for the period beginning January 1, 2002, and ending December 31, 2009.

House Bill

No provision.

Senate Amendment

The Senate amendment provides that an employee who resides in one area that is designated as a renewal community, but who works in a certain other area that also is designated as a renewal community qualifies for the renewal community employment credit. To qualify the area of residence and the area of employment must be in the same State and within five miles.

In addition, the Senate amendment provides that, at the request of the local community, the Secretary of Housing and Urban development may expand the size of an existing renewal community to include a census tract that satisfy eligibility standards based on the 2000 Census, but which did not qualify based on the 1990 Census solely by reason of applicable 1990 population or poverty requirements. The Senate amendment also permits, upon the request of

the local community, the Secretary of Housing and Urban Development to expand the size of an existing renewal community to include certain adjacent census tracts populated with 100 or fewer persons.

Effective date.–The Senate amendment provisions are effective as if included in the Community Renewal Tax Relief Act of 2000.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

22. Combat zone expansions (secs. 542 and 543 of the Senate amendment and sec. 112 of the Code)

Present Law

In general, gross income does not include compensation for active service in the armed forces of the United States below the grade of commissioned officer for any month during which the service person served in a combat zone.[375] For commissioned officers, the maximum excludible under this provision is the highest level of pay for an enlisted person. In general, the determination that an area is a combat zone is made by the President by an Executive Order.[376]

House Bill

No provision.

Senate Amendment

The Senate amendment removes the limitation on this exclusion for commissioned officers, so that their entire basic pay is excludible. The Senate amendment also provides that direct transit to and from a combat zone (not to exceed 14 days) is treated as service in a combat zone. The Senate amendment treats military service as part of Operation Iraqi Freedom in Guantanamo Bay, Cuba, and Diego Garcia as if it were in a combat zone.

Effective date.–The Senate amendment provision is effective on January 1, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

---

[375] Sec. 112.

[376] Sec. 112(c)(2).

23. Ratable income inclusion for citrus canker tree payments (sec. 544 of the Senate amendment and sec. 451 and 1033 of the Code)

Present Law

Generally, a taxpayer recognizes gain on the sale or exchange 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 the earliest date of the threat or imminence of requisition or condemnation of the converted property, whichever is earlier) and generally ends two years after the close of the first taxable year in which any part of the gain upon conversion is realized. Longer replacement periods are available in the case of real property and principal residences involuntarily converted as a result of Presidentially declared disaster.

House Bill

No provision.

Senate Amendment

The Senate amendment permits a taxpayer to elect to recognize any realized gain by reason of receiving a citrus canker tree payment ratably over a 10-year period beginning with the taxable year in which such payment is received or accrued by the taxpayer. The provision defines a citrus canker tree payment as a payment made to an owner of a commercial citrus grove to recover income that was lost as a result of the removal of commercial citrus trees to control canker under the amendments to the citrus canker regulations made by the final rule published in the Federal Register by the Secretary of the Agriculture on June 18, 2001. An election under the provision is made by attaching a statement to that effect in the taxpayer's return for the taxable year in which the payment is received or accrued in the manner as the Secretary prescribes. An election is binding for that taxable year and all subsequent taxable years.

The Senate amendment also extends the applicable period under section 1033 for a taxpayer to replace commercial citrus trees which are involuntarily converted under a public order as a result of citrus tree canker to four years. In addition, the Secretary of the Treasury is granted authority to further extend the replacement period on a regional basis if a State or Federal health authority determines that the land on which such trees grew is not free from the bacteria that causes citrus tree canker.

Effective date.–The Senate amendment provision is effective for taxable years beginning before, on, or after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

24. Exclusion of certain punitive damage awards (sec. 545 of the Senate amendment and sec. 104 of the Code)

Present Law

Under present law, gross income generally does not include the amount of any 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.[377] However, this exclusion does not apply to punitive damages.[378]

House Bill

No provision.

Senate Amendment

The Senate amendment provides an exclusion from gross income for any portion of an award of punitive damages in a civil action that is paid to a State under a split-award statute or any attorneys' fees or other costs incurred by the taxpayer in connection with obtaining such an award which are allocable to such portion.

Under the Senate amendment, a "split-award statute" is a State law that requires a fixed portion of an award of punitive damages in a civil action to be paid to the State.

Effective date.–The Senate amendment applies to awards made in taxable years ending after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

---

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

[378] *Id.*

25. Repeal of pre-1997 tax on certain imported recycled halons (sec. 546 of the Senate amendment and sec. 4682 of the Code)

Present Law

An excise tax is imposed on the sale or use by the manufacturer or importer of certain ozone-depleting chemicals (sec. 4681). The amount of tax generally is determined by multiplying the base tax amount applicable for the calendar year by an ozone-depleting factor assigned to each taxable chemical. The base tax amount was $5.80 per pound in 1996 and $6.25 per pound in 1997, and increased by $0.45 cents per pound per year thereafter. The ozone-depleting factors for taxable halons are three for halon-1211, 10 for halon-1301, and six for halon-2402.

In general, taxable chemicals that are recovered and recycled within the United States are exempt from tax. In addition, exemption is provided for imported recycled halon-1301 and halon-2402 if such chemicals are imported after December 31, 1996, from countries that are signatories to the Montreal Protocol on Substances that Deplete the Ozone Layer.

House Bill

No provision.

Senate Amendment

The Senate amendment provides that no tax is liable for imported recycled halon-1301 or halon-2402 if such chemicals were imported after December 31, 1993, from countries that were signatories to the Montreal Protocol on Substances that Deplete the Ozone Layer at the time such chemicals were imported. In addition, the Senate amendment provides that no tax is liable for imported recycled halon-1211 if such chemicals were imported after December 31, 1993 and before August 5, 1997, from countries that were signatories to the Montreal Protocol on Substances that Deplete the Ozone Layer at the time such chemicals were imported. If, before the end of the one-year period commencing with the date of enactment, any taxpayer who previously paid tax under the then prevailing law files for a refund or credit of taxes paid, such refund or credit is to be made.

Effective date.–The Senate amendment provision is effective upon the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

26. Modification of involuntary conversion rules for businesses affected by the September 11, 2001 terrorist attacks (sec. 547 of the Senate amendment and sec. 1400L of the Code)

Present Law

A taxpayer may elect not to recognize gain with respect to property that is involuntarily converted if the taxpayer acquires within an applicable period (the "replacement period") property similar or related in service or use (section 1033). If the taxpayer does not replace the converted property with property similar or related in service or use, then gain generally is recognized. If the taxpayer elects to apply the rules of section 1033, gain on the converted property is recognized only to the extent that the amount realized on the conversion exceeds the cost of the replacement property. In general, the replacement period begins with the date of the disposition 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.[379] The replacement period is extended to three years if the converted property is real property held for the productive use in a trade or business or for investment.[380]

The Jobs Creation and Worker Assistance Act of 2002[381] extends the replacement period to five years for a taxpayer to purchase property to replace property that was involuntarily converted within the New York Liberty Zone[382] as a result of the terrorist attacks that occurred on September 11, 2001. However, the five-year period is available only if substantially all of the use of the replacement property is in New York City. In all other cases, the present-law replacement period rules continue to apply.

House Bill

No provision.

Senate Amendment

For property that was involuntarily converted within the New York Liberty Zone as a result of the terrorist attacks that occurred on September 11, 2001, the Senate amendment provides that if a taxpayer is a member of an affiliated group of corporations filing a

---

[379] Section 1033(a)(2)(B).

[380] Section 1033(g)(4).

[381] Pub. Law No. 107-147, sec. 301 (2002).

[382] The "New York Liberty Zone" generally is the area located on or south of Canal street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan, New York, New York.

consolidated return that replacement property may be purchased by any member of the affiliated group (in lieu of the taxpayer).[383]

Effective date.–The Senate amendment provision is effective for involuntary conversions in the New York Liberty Zone occurring on or after September 11, 2001.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

[383] It is anticipated that the Secretary of the Treasury will issue guidance as may be necessary to ensure that gain shall not be recognized under the consolidated return provisions and to ensure that any investment adjustments, or any other adjustments under the consolidated regulations, accurately reflect the implications of permitting another member of the consolidated group to purchase the replacement property.

D. Medicare Provisions (secs. 561-576 of the Senate amendment)

Present Law

Standardized Amount Equalization

Present law pays rural and small urban facilities 1.6 percent less on every inpatient discharge than their counterparts in urban areas of a million or more people.

Equalization of Medicare Disproportionate Share (DSH) Payments

Present law differentiates between rural and urban hospitals that treat vulnerable populations.

Assistance for Low Volume Hospitals

Present law fails to recognize the special costs incurred by hospitals with less than 2,000 discharges per year.

Revision of Labor Share to 62 percent

Medicare's standardized amounts are apportioned into a labor-related amount (which is then adjusted by the wage index value of the area where the hospital is located or to which it has been reassigned) and a nonlabor-related amount (which is generally not subject to geographical adjustment). Under present law, the labor-related amount comprises 71.1 percent of the national standardized amount.

Extend Hold Harmless for Rural Hospitals under Hospital Outpatient Prospective Payment System

Present law payments to outpatient hospital departments vary from year to year.

Critical Access Hospital Improvements

Many rural hospitals have elected to become critical access hospitals (CAHs) under present law.

10-percent Add-on for Rural Home Health Agencies

Special add-on payment to rural home health agencies expired on April 1, 2003.

Five-percent Add-on for Clinic and Emergency Room Visits for Small Rural Hospitals

Present law treats clinic and emergency room visits no differently than other services provided by the hospital.

Five-percent Add-on for Rural Ground Ambulance Trips

Present law fails to compensate for the long distances rural ambulances drive to treat patients.

Exclusion of Services Provided By Rural Health Clinic-based Practitioners from SNF Consolidated Billing

Present law requires providers based in a rural health clinic to submit their bills for services provided to nursing home patients to the nursing home rather than to Medicare.

Make 10-percent Bonus Payments under Medicare Incentive Payment Program Automatic

Present law requires physicians participating in the Medicare Incentive Payment program to apply for bonus payments when they elect to serve in Health Professional Shortage Areas.

Two-Year Extension of Reasonable Cost Payments for Laboratory Tests in Sole Community Hospitals

Present law allows laboratory tests performed in sole community hospitals to be paid at their reasonable cost, rather than under a fee schedule.

Set Work, Practice Expense and Malpractice Geographic Indices for Physician Payments at 1.0

Present law adjusts three components of physician payments under the physician fee schedule based on geography.

10-Year Freeze in CPI Updates for Durable Medical Equipment, Prosthetics and Orthotics

Present law produces payment updates equal to CPI for providers and suppliers in this category.

Collect Coinsurance and Deductible Amounts for Clinical Laboratory Tests

Present law includes no cost-sharing obligation for clinical laboratory tests.

Limit Reimbursement for Currently Covered Drugs

Present law pays for limited prescription drugs and biologicals at 95 percent of the product's average wholesale price.

House Bill

No provision.

Senate Amendment

Standardized Amount Equalization

The Senate amendment raises the inpatient base rate for hospitals in rural and small urban areas to the same rate as that in large urban areas.

Equalization of Medicare Disproportionate Share (DSH) Payments

The Senate amendment equalizes payments to both rural and urban hospitals that receive Medicare DSH payments.

Assistance for Low Volume Hospitals

The Senate amendment improves payments for those hospitals with extremely low annual patient volume.

Revision of Labor Share to 62 percent

The Senate amendment reduces the labor-related amount to 62 percent of the national standardized amount.

Extend Hold Harmless for Rural Hospitals under Hospital Outpatient Prospective Payment System

The Senate amendment protects rural hospitals against possible reductions due to the new outpatient prospective payment system through 2006.

Critical Access Hospital Improvements

The Senate amendment (1) reinstates Periodic Interim Payment (PIP), which provides facilities with a steadier stream of payment in order to improve their cash flow; (2) eliminates the current requirement that CAH-based ambulance services be at least 35 miles from another ambulance service in order to receive cost-based payment; and (3) provides coverage for emergency on-call providers, and (4) excludes CAHs from the wage index calculation.

10-percent Add-on for Rural Home Health Agencies

The Senate amendment extends special add-on payments that expired April 1, 2003 to rural home health agencies and makes them permanent.

Five-percent Add-on for Clinic and Emergency Room Visits for Small Rural Hospitals

The Senate amendment increases Medicare payment for visits to small rural hospitals' outpatient clinics and emergency rooms, which serve a critical primary care function in rural areas.

Five-percent Add-on for Rural Ground Ambulance Trips

The Senate amendment extends a five-percent add-on payment for all ground ambulance trips provided in a rural area.

Exclusion of Services Provided By Rural Health Clinic-based Practitioners from SNF Consolidated Billing

The Senate amendment exempts practitioners based in rural health clinics from the requirement to submit their bills for services provided to nursing home patients to the nursing home rather than to Medicare, reducing administrative burdens and making their payments more predictable.

Make 10-percent Bonus Payments under Medicare Incentive Payment Program Automatic

Present law requires physicians participating in the Medicare Incentive Payment program to apply for bonus payments when they elect to serve in Health Professional Shortage Areas. The Senate amendment makes bonus payments automatic to physicians participating in the Medicare Incentive Payment program, eliminating bureaucratic barriers to receipt of such funds.

Two-Year Extension of Reasonable Cost Payments for Laboratory Tests in Sole Community Hospitals

The Senate amendment extends the allowance for laboratory tests performed in sole community hospitals to be paid at their reasonable cost, rather than under a fee schedule for an additional two years.

Set Work, Practice Expense and Malpractice Geographic Indices for Physician Payments at 1.0

The Senate amendment sets a floor of 1.0 on geographic adjustments to the work, practice expense and professional liability insurance components of physician payment.

10-Year Freeze in CPI Updates for Durable Medical Equipment, Prosthetics and Orthotics

The Senate amendment freezes CPI updates for payment for durable medical equipment, prosthetics, and orthotics for ten years.

Collect Coinsurance and Deductible Amounts for Clinical Laboratory Tests

The Senate amendment extends the same coinsurance and deductible rules to clinical laboratory tests that apply to all other Part B services.

Limit Reimbursement for Currently Covered Drugs

The Senate amendment lowers that amount paid for limited prescription drugs and biologicals to 85 percent of the product's average wholesale price, or the amount payable for the product during the last quarter of the previous year, whichever is lower.

Conference Agreement

The conference agreement does not in the Senate amendment provisions.

E. Provisions Relating to S Corporations
(secs. 581-594 of the Senate amendment and sections 1361-1379 of the Code)

1. Shareholders of an S corporation

Present Law

The taxable income or loss of an S corporation is taken into account by the corporation's shareholders, rather than by the entity, whether or not such income is distributed. A small business corporation may elect to be treated as an S corporation. A "small business corporation" is defined as a domestic corporation which is not an ineligible corporation and which does not have (1) more than 75-shareholders; (2) as a shareholder, a person (other than certain trusts, estates, charities, and qualified retirement plans) who is not an individual; (3) a nonresident alien as a shareholder; and (4) more than one class of stock. For purposes of the 75-shareholder limitation, a husband and wife are treated as one shareholder. An "ineligible corporation" means any corporation that is a member of an affiliated group, certain financial institutions that use the reserve method of accounting for bad debts, certain insurance companies, a section 936 corporation, or a DISC or former DISC.

House Bill

No provision.

Senate Amendment

The Senate amendment provision provides that all family members owning stock can elect to be treated as one shareholder. A family is defined as the lineal descendants of a common ancestor (and their spouses). The common ancestor cannot be more than six generations removed from the youngest generation of shareholder at the time the S election is made (or the effective date of this provision, if later). The election is made available to only one family per corporation, must be made with the consent of all shareholders of the corporation and remains in effect until terminated.

The Senate amendment provision increases the maximum number of eligible shareholders from 75 to 100.

Finally, under the Senate amendment nonresident aliens are allowed as beneficiaries of an electing small business trust.

Effective date.–The Senate amendment provisions apply to taxable years beginning after December 31, 2003, except that the provision relating to nonresident aliens is effective on date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

2. Termination of election and additions to tax due to passive investment income

Present Law

An S corporation is subject to corporate-level tax, at the highest marginal corporate tax rate, on its net passive income if the corporation has (1) subchapter C earnings and profits at the close of the taxable year and (2) gross receipts more than 25 percent of which are passive investment income.

In addition, an S corporation election is terminated whenever the corporation has subchapter C earnings and profits at the close of three consecutive taxable years and has gross receipts for each of such years more than 25 percent of which are passive investment income.

For these purposes, "passive investment income" generally means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (to the extent of gains). "Passive investment income" generally does not include interest on accounts receivable, gross receipts that are derived directly from the active and regular conduct of a lending or finance business, gross receipts from certain liquidations, or gain or loss from any section 1256 contract (or related property) of an options or commodity dealer. "Net passive income" is defined as passive investment income reduced by the allowable deductions that are directly connected with the production of the income.

House Bill

No provision.

Senate Amendment

The Senate amendment provision increases the 25-percent threshold to 60 percent.

Also, the Senate amendment repeals capital gain as a category of passive income.

Effective date.–The Senate amendment provision applies to taxable years beginning after December 31, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

3. Treatment of S corporation shareholders

(a) In general

Present Law

In general, each S corporation shareholder takes into account its pro rata share of the S corporation income and loss for the taxable year.

House Bill

No provision.

Senate Amendment

The Senate amendment provision makes the following changes in the treatment of S corporation shareholders:

Under the Senate amendment provision, if a shareholder's stock in an S corporation is transferred incident to a divorce decree, the pro rata share of any suspended corporate loss is transferred to the transferee spouse.

Under the Senate amendment provision, the beneficiary of a qualified subchapter S trust is allowed the suspended losses under the at-risk rules and the passive loss rules when the trust disposes of the stock.

Effective date.–The Senate amendment provisions apply to taxable years beginning after December 31, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

(b) Electing small business trusts

Present Law

Under present law, an electing small business trust ("ESBT") may be an S corporation shareholder. In general, the beneficiaries of an ESBT must be individuals and others taxpayers that may own stock in an S corporation directly. Each potential current beneficiary of the trust is counted as a shareholder in determining whether or not the corporation meets the requirement that an S corporation have no more than 75 shareholders.

The portion of the trust consisting of S corporation stock is treated as a separate trust. The trust is taxed at the maximum trust tax rate (which is the same as the maximum individual tax rate) on the items of income, deduction, gain, or loss passing through from the S corporation. The remaining portion of the trust is treated as a separate trust taxed under the normal rules relating to the taxation of trusts and beneficiaries. In computing the amount of the distribution deduction for the trust, no subchapter S items are taken into account.

House Bill

No provision.

Senate Amendment

Under the Senate amendment provision, unexercised powers of appointment are disregarded in determining the beneficiaries of an electing small business trust.

Under the Senate amendment provision, the treatment of distributions from an electing small business trust is clarified by treating distributions from each portion (i.e., the portion attributable to the S corporation stock and the remaining portion) of the trust as separate distributions.

Effective date.–The Senate amendment provisions apply to taxable years beginning after December 31, 2003.

Conference Agreement

The conference agreement does not include the provision in the Senate amendment provision.

4. Provisions relating to banks

(a) IRAs holding bank stock

Present Law

An individual retirement arrangement ("IRA") may not hold stock in an S corporation.

The Code contains rules prohibiting certain transactions between disqualified persons and certain tax-favored retirement arrangements, including IRAs. These rules are designed to prevent certain self-dealing transactions. For example, the sale of an asset held by an IRA to the beneficiary of the IRA is a prohibited transaction. In general, an excise tax is imposed on prohibited transactions. In the case of an IRA, however, if the IRA beneficiary engages in a prohibited transaction, the excise tax does not apply and, instead, the IRA ceases to be an IRA.

House Bill

No provision.

Senate Amendment

The Senate amendment provision provides that the sale of holding bank stock held in an IRA to the beneficiary of the IRA is not a prohibited transaction, in order to allow the corporation to be eligible to elect to be an S corporation.

Effective date.–The Senate amendment provision applies to stock held by an IRA on the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

(b) Exclusion of investment securities income from passive income test for bank S corporations

Present Law

An S corporation is subject to corporate-level tax, at the highest marginal corporate tax rate, on its net passive income if the corporation has (1) subchapter C earnings and profits at the close of the taxable year and (2) gross receipts more than 25 percent of which are passive investment income.

In addition, an S corporation election is terminated whenever the corporation has subchapter C earnings and profits at the close of three consecutive taxable years and has gross receipts for each of such years more than 25 percent of which are passive investment income.

For these purposes, "passive investment income" generally means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (to the extent of gains). "Passive investment income" generally does not include interest on accounts receivable, gross receipts that are derived directly from the active and regular conduct of a lending or finance business, gross receipts from certain liquidations, or gain or loss from any section 1256 contract (or related property) of an options or commodity dealer. "Net passive income" is defined as passive investment income reduced by the allowable deductions that are directly connected with the production of the income.

House Bill

No amendment.

Senate Amendment

The Senate amendment provision provides that, in the case of a bank or bank holding company, passive income does not include interest and does not include dividends on assets required to be held by the bank or bank holding company.

Effective date.–The Senate amendment provision applies to taxable years beginning after December 31, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

(c) Treatment of qualifying director shares

Present Law

A small business corporation may elect to be treated as an S corporation. A "small business corporation" is defined as a domestic corporation which is not an ineligible corporation and which does not have (1) more than 75 shareholders; (2) as a shareholder, a person (other than

certain trusts, estates, charities, or qualified retirement plans) who is not an individual; (3) a nonresident alien as a shareholder; and (4) more than one class of stock.

House Bill

No provision.

Senate Amendment

Under the Senate amendment provision, shares held by reason of being a bank director that are subject to an agreement pursuant to which the holder is required to dispose of the shares upon termination of the holder's status as a director at the same price the individual acquired the shares are not treated as a second class of stock. Distributions are treated like interest payments.

Effective date.–The Senate amendment provision applies to taxable years beginning after December 31, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

5. Qualified subchapter S subsidiaries

(a) Relief from inadvertently invalid qualified subchapter S subsidiaries and elections and terminations

Present Law

Under present law, inadvertent subchapter S elections and terminations may be waived.

House Bill

No provision.

Senate Amendment

The Senate amendment provision allows inadvertent qualified subchapter S subsidiary elections and terminations to be waived by the IRS.

Effective date.–The Senate amendment provision applies to taxable years beginning after December 31, 2002.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

(b) Information returns for qualified subchapter S subsidiaries

Present Law

Under present law, a wholly owned subsidiary of an S corporation may elect to be treated as not a separate corporation. The assets, liabilities, and items of income, deduction, and credit of the subsidiary are treated as assets, liabilities, and items of the parent S corporation.

House Bill

No provision

Senate Amendment

The Senate amendment provision provides authority to the Secretary of the Treasury to provide guidance regarding information returns of subchapter S subsidiaries.

Effective date.–The Senate amendment provision applies to taxable years beginning after December 31, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

6. Elimination of all earnings and profits attributable to pre-1983 years

Present Law

The Small Business Job Protection Act of 1996 provided that if a corporation was an S corporation for its first taxable year beginning after 1996, the accumulated earnings and profits of the corporation were reduced as of the beginning of that year by the accumulated earnings and profits (if any) accumulated in a taxable year beginning before 1983 for which the corporation was an electing small business corporation under subchapter S.

House Bill

No provision.

Senate Amendment

The Senate amendment provision eliminates all accumulated earnings and profits of a corporation accumulated in a taxable year beginning before 1983 for which the corporation was an electing small business corporation under subchapter S.

Effective date.–The Senate amendment provision applies to taxable years beginning after December 31, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

VIII. BLUE RIBBON COMMISSION ON COMPREHENSIVE TAX REFORM (secs. 601-607 of the Senate amendment)

Present Law

No provision.

House Bill

No provision.

Senate Amendment

The Senate amendment establishes the Blue Ribbon Commission on Comprehensive Tax Reform (the "Commission"). The Commission is composed of 12 members, of whom: (1) one is the Chairman of the Board of the Federal Reserve System; (2) two are appointed by the majority leader of the Senate; (3) two are appointed by the minority leader of the Senate; (4) two are appointed by the Speaker of the House of Representatives; (5) two are appointed by the minority leader of the House of Representatives; and (6) three are appointed by the President, of which no more than two will be of the same party as the President. Members of the Commission may be employees or former employees of the Federal Government. Appointments of Commission members will be made not later than July 30, 2003. Members of the Commission will be appointed for the life of the Commission. Any vacancy in the Commission will not affect its powers but will be filled in the same manner as the original appointment.

The Commission will hold its first meeting not later than 30 days after the date on which all Commission members have been appointed. The President will select a Commission Chairman ("Chairman") and Vice Chairman from among the members of the Commission. The Commission will meet at the call of the Chairman. A majority of the members of the Commission will constitute a quorum, but a lesser number of members may hold hearings (discussed below).

The Commission will conduct a thorough study of all matters relating to a comprehensive reform of the Federal tax system, including the reform of the Internal Revenue Code of 1986 and the implementation (if appropriate) of other types of tax systems. The Commission will develop recommendations on how to comprehensively reform the Federal tax system in a manner that generates appropriate revenue for the Federal Government. Not later than 18 months after the date on which all initial members of the Commission have been appointed, the Commission will submit a report to the President and Congress which will contain a detailed statement of the findings and conclusions of the Commission, together with its recommendations for such legislation and administrative actions as it considers appropriate.

The Commission may hold such hearings, sit and act at such times and places, take such testimony, and receive such evidence as the Commission considers advisable to carry out the amendment. Additionally, the Commission may secure directly from any Federal department or agency such information as the Commission considers necessary to carry out the amendment. Upon request of the Chairman, the head of such department or agency will furnish such

information to the Commission. The Commission may use the United States mails in the same manner and under the same condition as other departments and agencies of the Federal Government. The Commission may accept, use, and dispose of gifts or donations of services or property.

Each member of the Commission who is not an officer or employee of the Federal Government will be compensated at a rate equal to the daily equivalent of a prescribed annual rate of pay[384] for each day (including travel time) during which such member is engaged in the performance of the duties of the Commission. All members of the Commission who are officers or employees of the United States will serve without compensation in addition to that received for their services as officers or employees of the United States. Commission members will be allowed travel expenses, including per diem in lieu of subsistence, at rates authorized for employees of agencies while away from their homes or regular places of business in the performance of services for the Commission.[385]

The Chairman, without regard to the civil service laws and regulations, may appoint and terminate an executive director and such other additional personnel as may be necessary to enable the Commission to perform its duties. The employment of an executive director will be subject to confirmation by the Commission. The Chairman may fix the compensation of the executive director and other personnel without regard to classification of positions and general schedule pay rates,[386] except that the rate of pay for the executive director and other personnel may not exceed the rate payable for level V of the executive schedule.[387]

Any employee of the Federal Government may be detailed to the Commission without reimbursement, and such detail will be without interruption or loss of civil service status or privilege. The Chairman may procure temporary and intermittent services[388] at rates for individuals which do not exceed the daily equivalent of the annual rate of basic pay prescribed for level V of the executive schedule.

The Commission will terminate 90 days after the date on which the Commission submits the report required by the provision. Such sums as are necessary to carry out the Senate amendment are appropriated.

Effective date.–The Senate amendment is effective on the date of enactment.

---

[384] The applicable rate of pay is the basic pay prescribed for level IV of the Executive Schedule under 5 U.S.C. 5315.

[385] Subchapter I of chapter 57 of title 5, U.S.C.

[386] Chapter 51 and subchapter III of chapter 53 of title 5, U.S.C.

[387] 5 U.S.C. 5316.

[388] 5 U.S.C. 3109(b).

Conference Agreement

The conference agreement does not include the Senate amendment provision.

IX. REIT PROVISIONS

A. REIT Modification Provisions
(secs. 701-707 of the Senate amendment and secs. 856 and 857 of the Code)

Present Law

In general

Real estate investment trusts ("REITs") are treated, in substance, as pass-through entities under present law. Pass-through status is achieved by allowing the REIT a deduction for dividends paid to its shareholders. REITs are generally restricted to investing in passive investments primarily in real estate and securities.

A REIT must satisfy four tests on a year-by-year basis: organizational structure, source of income, nature of assets, and distribution of income. Whether the REIT meets the asset tests is generally measured each quarter.

Organizational structure requirements

To qualify as a REIT, an entity must be for its entire taxable year a corporation or an unincorporated trust or association that would be taxable as a domestic corporation but for the REIT provisions, and must be managed by one or more trustees. The beneficial ownership of the entity must be evidenced by transferable shares or certificates of ownership. Except for the first taxable year for which an entity elects to be a REIT, the beneficial ownership of the entity must be held by 100 or more persons, and the entity may not be so closely held by individuals that it would be treated as a personal holding company if all its adjusted gross income constituted personal holding company income. A REIT is disqualified for any year in which it does not comply with regulations to ascertain the actual ownership of the REIT's outstanding shares.

Income requirements

In order for an entity to qualify as a REIT, at least 95 percent of its gross income generally must be derived from certain passive sources (the "95-percent income test"). In addition, at least 75 percent of its income generally must be from certain real estate sources (the "75-percent income test"), including rents from real property (as defined) and gain from the sale or other disposition of real property.

Qualified rental income

Amounts received as impermissible "tenant services income" are not treated as rents from real property.[389] In general, such amounts are for services rendered to tenants that are not

[389] A REIT is not treated as providing services that produce impermissible tenant services income if such services are provided by an independent contractor from whom the REIT does not derive or receive any income. An independent contractor is defined as a person who does not own, directly or indirectly, more than 35 percent of the shares of the REIT. Also, no

"customarily furnished" in connection with the rental of real property.[390] Special rules also permit amounts to be received from certain "foreclosure property" treated as such for 3 years after the property is acquired by the REIT in foreclosure after a default (or imminent default) on a lease of such property or an indebtedness which such property secured.

Rents from real property, for purposes of the 95-percent and 75-percent income tests, generally do not include any amount received or accrued from any person in which the REIT owns, directly or indirectly, 10 percent or more of the vote or value.[391] An exception applies to rents received from a taxable REIT subsidiary ("TRS") (described further below) if at least 90 percent of the leased space of the property is rented to persons other than a TRS or certain related persons, and if the rents from the TRS are substantially comparable to unrelated party rents.[392]

Certain hedging instruments

Except as provided in regulations, a payment to a REIT under an interest rate swap or cap agreement, option, futures contract, forward rate agreement, or any similar financial instrument, entered into by the trust in a transaction to reduce the interest rate risks with respect to any indebtedness incurred or to be incurred by the REIT to acquire or carry real estate assets, and any gain from the sale or disposition of any such investment, is treated as income qualifying for the 95-percent income test.

Tax if qualified income tests not met

If a REIT fails to meet the 95-percent or 75-ercent income tests but has set out the income it did receive in a schedule and any error in the schedule is due to reasonable cause and not willful neglect, then the REIT does not lose its REIT status but instead pays a tax measured by the greater of the amount by which 90 percent [393] of the REIT's gross income exceeds the amount of items subject to the 95-percent test, or the amount by which 75 percent of the REIT's gross income exceeds the amount of items subject to the 75-percent test.[394]

---

more than 35 percent of the total shares of stock of an independent contractor (or of the interests in net assets or net profits, if not a corporation) can be owned directly or indirectly by persons owning 35 percent or more of the interests in the REIT.

[390] Rents for certain personal property leased in connection are treated as rents from real property if the fair market value of the personal property does not exceed 15 percent of the aggregate fair market values of the real and personal property

[391] Section 856(d)(2)(B).

[392] Section 856(d)(8).

[393] Prior to 1999, the rule had applied to the amount by which 95 percent of the income exceeded the items subject to the 95 percent test.

[394] The ratio of the REIT's net to gross income is applied to the excess amount, to determine the amount of tax (disregarding certain items otherwise subject to a 100-percent tax).

Income or loss from prohibited transactions

In general, a REIT must derive its income from passive sources and not engage in any active trade or business. A 100 percent tax is imposed on the net income of a REIT from "prohibited transactions". A prohibited transaction is the sale or other disposition of property described in section 1221(1) of the Code (property held for sale in the ordinary course of a trade or business) other than foreclosure property.[395] A safe harbor is provided for certain sales of rent producing real property that otherwise might be considered prohibited transactions. The safe harbor is limited to seven or fewer sales a year or, alternatively, any number of sales provided that the aggregate adjusted basis of the property sold does not exceed 10 percent of the aggregate basis of all the REIT's assets at the beginning of the REIT's taxable year. The safe harbor only applies to property that has been held by the REIT for at least 4 years. In addition, property is eligible for the safe harbor only if the aggregate expenditures made directly or indirectly by the REIT during the 4-year period prior to date of sale do not exceed 30 percent of the net selling price of the property.

Certain timber income

REITs have been formed to hold land on which trees are grown. Upon maturity of the trees, the standing trees are sold by the REIT to its taxable REIT subsidiary, which cuts and logs the trees and processes the timber to produce lumber, lumber products such a plywood or composite. The Internal Revenue Service has issued private letter rulings in particular instances stating that the income can qualify as REIT real property income because the uncut timber and the timberland on which the timber grew is considered real property and the sale of uncut trees can qualify as capital gain derived from the sale of real property.[396]

Asset requirements

To satisfy the asset requirements to qualify for treatment as a REIT, at the close of each quarter of its taxable year, an entity must have at least 75 percent of the value of its assets invested in real estate assets, cash and cash items, and government securities (the "75-percent asset test"). The term real estate asset is defined to mean real property (including interests in real property and mortgages on real property) and interests in REITs.

In effect, the formula seeks to require that all of the REIT net income attributable to the failure of the income tests will be paid as tax. Sec. 857(b)(5).

[395] Thus, the 100 percent tax on prohibited transactions helps to ensure that the REIT is a passive entity and may not engage in ordinary retailing activities such as sales to customers of condominium units or subdivided lots in a development project.

[396] See, e.g., PLR 200052021, PLR 199945055, PLR 19927021, PLR 8838016. A private letter ruling may be relied upon only by the taxpayer to which the ruling is issued. However, such rulings provide an indication of administrative practice.

Limitation on investment in other entities

A REIT is limited in the amount that it can own in other corporations. Specifically, a REIT cannot own securities (other than Government securities and certain real estate assets) in an amount greater than 25 percent of the value of REIT assets. In addition, it cannot own such securities of any one issuer representing more than 5 percent of the total value of REIT assets or more than 10 percent of the voting securities or 10 percent of the value of the outstanding securities of any one issuer. Securities for purposes of these rules are defined by reference to the Investment Company Act of 1940.

"Straight debt" exception

Securities of an issuer that are within a safe-harbor definition of "straight debt" (as defined for purposes of subchapter S[397] are not taken into account in applying the limitation that a REIT may not hold more than 10 percent of the value of outstanding securities of a single issuer, if : 1) the issuer is an individual, or 2) the only securities of such issuer held by the REIT or a taxable REIT subsidiary of the REIT are straight debt, or 3) the issuer is a partnership and the trust holds at least a 20 percent profits interest in the partnership.

Straight debt is defined as a written or unconditional promise to pay on demand or on a specified date a sum certain in money if (i) the interest rate (and interest payment dates) are not contingent on profits, the borrower's discretion, or similar factors; (ii) there is no convertibility (directly or indirectly) into stock; and (iii) the creditor is an individual (other than a nonresident alien), an estate, certain trusts, or a person which is actively and regularly engaged in the business of lending money.

Certain subsidiary ownership permitted with income treated as income of the REIT

Under one exception to the rule limiting a REIT's securities holdings to no more than 10 percent of the vote or value of a single issuer, a REIT can own 100 percent of the stock of a corporation, but in that case the income and assets of such corporation are treated as income and assets of the REIT.

Special rules for Taxable REIT subsidiaries

Under another exception to the general rule limiting REIT securities ownership of other entities, a REIT can own stock of a taxable REIT subsidiary ("TRS"), generally, a corporation other than a real estate investment trust[398] with which the REIT makes a joint election to be subject to special rules. A TRS can engage in active business operations that would produce income that would not be qualified income for purposes of the 95-percent or 75-percent income

---

[397] Section 1361(c)(5), without regard to paragraph (B)(iii) thereof.

[398] Certain corporations are not eligible to be a TRS, such as a corporation which directly or indirectly operates or manages a lodging facility or a health care facility or directly or indirectly provides to any other person rights to a brand name under which any lodging facility or health care facility is operated. Sec. 856((l)(3).

tests for a REIT, and that income is not attributed to the REIT. For example a TRS could provide noncustomary services to REIT tenants, or it could engage directly in the active operation and management of real estate (without use of an independent contractor); and the income the TRS derived from these nonqualified activities would not be treated as disqualified REIT income. Transactions between a TRS and a REIT are subject to a number of specified rules that are intended to prevent the TRS (taxable as a separate corporate entity) from shifting taxable income from its activities to the pass through entity REIT or from absorbing more than its share of expenses. Under one rule, a 100 percent excise tax is imposed on rents, deductions, or interest paid by the TRS to the REIT to the extent such items would exceed an arm's length amount as determined under section 482.[399]

Rents subject to the 100 percent excise tax do not include rents for services of a TRS that are for services customarily furnished or rendered in connection with the rental of real property.

They also do not include rents from a TRS that are for real property or from incidental personal property provided with such real property.

Income distribution requirements

A REIT is generally required to distribute 90 percent of its income before the end of its taxable year, as deductible dividends paid to shareholders. This rule is similar to a rule for regulated investment companies ("RICs") that requires distribution of 90 percent of income. Both RICS and REITs can make certain "deficiency dividends" after the close of the taxable year, and have these treated as made before the end of the year. Deficiency dividends may be declared on or after the date of "determination". A determination is defined to include only (i) a final decision by the Tax Court or other court of competent jurisdiction, (ii) a closing agreement under section 7121, or (iii) under Treasury regulations, an agreement signed by the Secretary and the REIT.

House Bill

No provision.

Senate Amendment

The Senate amendment makes a number of modifications to the REIT rules.

Straight debt modification

The provision modifies the definition of "straight debt" for purposes of the limitation that a REIT may not hold more than 10 percent of the value of the outstanding securities of a single issuer, to provide more flexibility than the present law rule. In addition, except as provided in regulations, neither such straight debt nor certain other types of securities are considered "securities" for purposes of this rule.

---

[399] If the excise tax applies, the item is not also reallocated back to the TRS under section 482.

Straight debt securities

"Straight-debt" is still defined by reference to section 1361(c)(5), however, without regard to subparagraph (B)(iii) thereof (limiting the nature of the creditor).

Special rules are provided permitting certain contingencies for purposes of the REIT provision. Any interest or principal shall not be treated as failing to satisfy section 1361(c)(5)(B)(i) solely by reason of the fact that the time of payment of such interest or principal is subject to a contingency, but only if one of several factors applies. The first type of contingency that is permitted is one that does not have the effect of changing the effective yield to maturity, as determined under section 1272, other than a change in the annual yield to maturity which either (i) does not exceed the greater of ¼ of 1 percent or 5 percent of the annual yield to maturity, or (ii) results solely from a default or the exercise of a prepayment right by the issuer of the debt.

The second type of contingency that is permitted is one under which neither the aggregate issue price nor the aggregate face amount of the debt instruments held by the REIT exceeds $1,000,000 and not more than 12 months of unaccrued interest can be required to be prepaid thereunder.

The bill eliminates the present law rule requiring a REIT to own a 20 percent equity interest in a partnership in order for debt to qualify as "straight debt". The bill instead provides new "look-through" rules determining a REIT partner's share of partnership securities, generally treating debt to the REIT as part of the REIT's partnership interest for this purpose, except in the case of otherwise qualifying debt of the partnership.

Certain corporate or partnership issues that otherwise would be permitted to be held without limitation under the special straight debt rules described above will not be so permitted if the REIT holding such securities, and any of its taxable REIT subsidiaries, holds any securities of the issuer which are not permitted securities (prior to the application of this rule) and have an aggregate value greater than 1 percent of the issuer's outstanding securities.

Other securities

Except as provided in regulations, the following also are not considered "securities" for purposes of the rule that a REIT cannot own more than 10 percent of the value of the outstanding securities of a single issuer: (i) any loan to an individual or an estate, (ii) any section 467 rental agreement, (as defined in section 467(d)), other than with a person described in section 856(d)(2)(B), (iii) any obligation to pay rents from real property, (iv) any security issued by a State or any political subdivision thereof, the District of Columbia, a foreign government, or any political subdivision thereof, or the Commonwealth of Puerto Rico, but only if the determination of any payment received or accrued under such security does not depend in whole or in part on the profits of any entity not described in this category, or payments on any obligation issued by such an entity, (v) any security issued by a real estate investment trust; (vi) any other arrangement that, as determined by the Secretary, is excepted from the definition of a security.

Safe harbor testing date for certain rents

The bill provides specific safe-harbor rules regarding the dates for testing whether 90 percent of a REIT property is rented to unrelated persons and whether the rents paid by related persons are substantially comparable to unrelated party rents. These testing rules are provided solely for purposes of the special provision permitting rents received from a related party to be treated as qualified rental income for purposes of the income tests.[400]

Customary services exception

The bill prospectively eliminates the safe harbor allowing rents received by a REIT to be exempt from the 100 percent excise tax if the rents are for customary services performed by the TRS[401] or are from a TRS and are for the provision of certain incidental personal property. Instead, such payments would be free of the excise tax if they satisfy the present law safe-harbor that applies if the REIT pays the TRS at least 150 percent of the cost to the TRS of providing any services.

Hedging rules

The rules governing the tax treatment of arrangements engaged in by a REIT to reduce interest rate risks are prospectively conformed to the rules included in section 1221.

95-percent gross income requirement

The bill prospectively amends the tax liability owed by the REIT when it fails to meet the 95-percent of gross income test by applying a taxable fraction based on 95 percent, rather than 90 percent of the REIT's gross income.

Safe harbor from prohibited transactions for certain timberland sales

The bill provides that a sale of a real estate asset will not be a prohibited transaction the following six requirements are met:

(1) The asset must have been held for at least 4 years in the trade or business of producing timber;

(2) The aggregate expenditures made the REIT (or a partner of the REIT) during the 4-year period preceding the date of sale that are includible in the basis of the property that are directly related to the operation of the property for the

---

[400] The proposal does not modify any of the standards of section 482 as they apply to REITS and to taxable REIT subsidiaries.

[401] Although a REIT could itself provide such services and receive the income for them without receiving any disqualified income, in that case the REIT itself would be bearing the cost of providing the service. Under the present law exception for a TRS providing such service, there is no explicit requirement that the TRS be reimbursed for the full cost of the service.

production of timber or for the preservation of the property for use as timberland must not exceed 30 percent of the net selling price of the property;

(3) The aggregate expenditures made the REIT (or a partner of the REIT) during the 4-year period preceding the date of sale that are includible in the basis of the property that do not qualify under the second requirement (i.e., those expenditures are not directly related to the operation of the property for the production of timber or the preservation of the property for use as timberland) must not exceed 5 percent of the net selling price of the property;

(4) The REIT either (i) does not make more than 7 sales of property (other than sales of foreclosure property or sales to which 1033 applies) or (ii) the aggregate adjusted bases (as determined for purposes of computing earnings and profits) of property sold during the year (other than sales of foreclosure property or sales to which 1033 applies) does not exceed 10 percent of the aggregate bases (as determined for purposes of computing earnings and profits)of property of all assets of the REIT as of the beginning of the year;

(5) Substantially all of the marketing expenditure with respect to the property are made by persons who an independent contractor (as defined by section 856(d)(3) with respect to the REIT and from whom the REIT does not derive any income; and

(6) The sales price of the sale of the property to a taxable REIT subsidiary cannot be based in whole or in part on the income or profits that the subsidiary derives from the sales of such properties.

Costs that are not includible in the basis of the property are not counted towards either the 30 or 5 percent requirements.

Capital expenditures counted towards 30-percent requirement

Capital expenditures counted towards the 30-percent limit are those expenditures that are includible in the basis of the property (other than timberland acquisition expenditures), and that are directly related to operation of the property for the production of timber, or for the preservation of the property for use as timberland. These capital expenditures are those incurred directly in the operation of raising timber (*i.e.*, silviculture), as opposed to capital expenditures incurred in the ownership of undeveloped land. In general, these capital expenditures incurred directly in the operation of raising timber include capital expenditures incurred by the REIT to create an established stand of growing trees. A stand of trees is considered established when a target stand exhibits the expected growing rate and is free of non-target competition (e.g., hardwoods; grasses, brush, etc.) that may significantly inhibit or threaten the target stand survival. The costs commonly incurred during stand establishment are: (1) site preparation including manual or mechanical scarification, manual or mechanical cutting, disking, bedding, shearing, raking, piling, broadcast and windrow/pile burning (including slash disposal costs as required for stand establishment); 2) site regeneration including manual or mechanical hardwood coppice; (3) chemical application via aerial or ground to eliminate or reduce vegetation; (4)

nursery operating costs including personnel salaries and benefits, facilities costs, cone collection and seed extraction, and other costs directly attributable to the nursery operations (to the extent such costs are allocable to seedlings used by the REIT); (5) seedlings including storage, transportation and handling equipment; (6) direct planting of seedlings; (7) initial stand fertilization, up through stand establishment; (8) construction cost of road to be used for removal of logs or fire protection; (9) environmental costs (*i.e.*, habitat conservation plans), (10) any post stand capital establishment costs (*e.g.*, "mid-term fertilization costs)."

Capital expenditures counted towards 5-percent requirement

Capital expenditures counted towards the 5-percent limit are those capital expenditures incurred in the ownership of undeveloped land that are not incurred in the direct operation of raising timber (*i.e.*, silviculture). This category of capital expenditures includes (1) expenditures to separate the REIT's holdings of land into separate parcels; (2) costs of granting leases or easements to cable, cellular or similar companies, (3) costs in determining the presence or quality of minerals located on the land; (4) costs incurred to defend changes in law that would limit future use of the land by the REIT or a purchaser from the REIT; and (5) costs incurred to determine alternative uses of the land (*e.g.*, recreational use); and (6) development costs of the property incurred by the REIT (*e.g.*, engineering, surveying, legal, permit, consulting, road construction, utilities, and other development costs for use other than to grow timber).

Effective date

The bill is generally effective for taxable years beginning after December 31, 2000.

However, some of the provisions are effective for taxable years beginning after the date of enactment. These are: the new “look through” rules determining a REIT partner’s share of partnership securities for purposes of the “straight debt” rules; the provision changing the 90-percent of gross income reference to 95 percent, for purposes of the tax liability if a REIT fails to meet the 95-ercent of gross income test; the new hedging definition; the rule modifying the treatment of rents with respect to customary services; and the safe harbor from prohibited transactions relating to timberland sales.[402]

Conference Agreement

The conference agreement does not include the Senate amendment provision.

[402] The provision relating to timberland sales is not intended to change present law regarding when structures involving timberland may qualify for REIT status.

B. REIT Savings Provisions
(sec. 711 of the Senate amendment and secs. 856, 857 and 860 of the Code)

Present Law

A REIT loses its status as a REIT, and becomes subject to tax as a C corporation, if it fails to meet specified tests regarding the sources of its income, the nature and amount of its assets, its structure, and the amount of its income distributed to shareholders.[403]

In the case of a failure to meet the source of income requirements, if the failure is due to reasonable cause and not to willful neglect, the REIT may continue its REIT status if it pays the disallowed income as a tax to the Treasury.[404]

There is no similar provision that allows a REIT to pay a penalty and avoid disqualification in the case of other qualification failures.

A REIT may make a deficiency dividend after a determination is made that it has not distributed the correct amount of its income, and avoid disqualification. The Code provides only for determinations involving a controversy with the IRS and does not provide for a REIT to make such a distribution on its own initiative.

House Bill

No provision.

Senate Amendment

Under the Senate amendment, a REIT may avoid disqualification in the event of certain failures of the requirements for REIT status, provided that 1) the failure was due to reasonable cause and not willful neglect, 2) the failure is corrected, and 3) a penalty amount is paid.

One requirement of present law is that, with certain exceptions, (i) not more than 5 percent of the value of total REIT assets may be represented by securities of one issuer, and (ii) a REIT may not hold securities possessing more than 10 percent of the total voting power or 10 percent of the total value of the outstanding securities of any one issuer.[405] The requirements must be satisfied each quarter.

---

[403] See description of *Present Law* under REIT modification provisions, *supra.*

[404] Sec. 856(c)(6) and Sec. 857(b)(5).

[405] Sec. 856(c)(4)(B)(iii). These rules do not apply to securities of a taxable REIT subsidiary, or to securities that qualify for the 75 percent asset test of section 856(c)(4)(A), such as real estate assets, cash items (including receivables), or Government securities.

Certain de minimis asset failures of 5-percent or 10-percent tests

The bill provides that a REIT will not lose its REIT status for failing to satisfy these requirements in a quarter if the failure is due to the ownership of assets the total value of which does not exceed the lesser of (i) 1 percent of the total value of the REIT's assets at the end of the quarter for which such measurement is done or (ii) 10 million dollars; provided in either case that the REIT either disposes of the assets within 6 months after the last day of the quarter in which the REIT identifies the failure (or such other time period prescribed by the Treasury), or otherwise meets the requirements of those rules by the end of such time period.[406]

Larger asset test failures (whether of 5-percent or 10-percent tests, or of 75-percent or other asset tests)

If a REIT fails to meet any of the asset test requirements requirements for a particular quarter and the failure exceeds the de minimis threshold described above, then the REIT still will be deemed to have satisfied the requirements if: (i) following the REIT's identification of the failure, the REIT files a schedule with a description of each asset that caused the failure, in accordance with regulations prescribed by the Treasury; (ii) the failure was due to reasonable cause and not to willful neglect, (iii) the REIT disposes of the assets within 6 months after the last day of the quarter in which the identification occurred or such other time period as is prescribed by the Treasury (or the requirements of the rules are otherwise met within such period), and (iv) the REIT pays a tax on the failure.

The tax that the REIT must pay on the failure is the greater of (i) $50,000, or (ii) an amount determined (pursuant to regulations) by multiplying the highest rate of tax for corporations under section 11, times the net income generated by the assets for the period beginning on the first date of the failure and ending on the date the REIT has disposed of the assets (or otherwise satisfies the requirements).

Such taxes are treated as excise taxes, for which the deficiency provisions of the excise tax subtitle of the Code (subtitle F) apply.

Conforming reasonable cause and reporting standard for failures of income tests

The bill conforms the reporting and reasonable cause standards for failure to meet the income tests to the new asset test standards. However, the bill does not change the rule under section 857(b)(5) that for income test failures, all of the net income attributed to the disqualified gross income is paid as tax.

Other failures

The bill adds a provision under which, if a REIT fails to satisfy one or more requirements for REIT qualification, other than the 95-percent and 75-percent gross income tests and other

[406] A REIT might satisfy the requirements without a disposition, for example, by increasing its other assets in the case of the 5 percent rule; or by the issuer modifying the amount or value of its total securities outstanding in the case of the 10 percent rule.

than the new rules provided for failures of the asset tests, the REIT may retain its REIT qualification if the failures are due to reasonable cause and not willful neglect, and if the REIT pays a penalty of $50,000 for each such failure.

Taxes and penalties paid deducted from amount required to be distributed

Any taxes or penalties paid under the provision are deducted from the net income of the REIT in determining the amount the REIT must distribute under the 90 percent distribution requirement.

Expansion of deficiency dividend procedure

The Senate amendment expands the circumstances in which a REIT may declare a deficiency dividend, by allowing such a declaration to occur after the REIT unilaterally has identified a failure to pay the relevant amount. Thus, the declaration need not await a decision of the Tax Court, a closing agreement, or an agreement signed by the Secretary of the Treasury.

Effective date.–The Senate amendment provision is effective for taxable years beginning after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

X. EXTENSION OF CERTAIN EXPIRING PROVISIONS

A. Tax on Failure to Comply with Mental Health Parity Requirements (sec. 801 of the Senate amendment and sec. 9812 of the Code)

Present Law

The Mental Health Parity Act of 1996 amended ERISA and the Public Health Service Act to provide that group health plans that provide both medical and surgical benefits and mental health benefits cannot impose aggregate lifetime or annual dollar limits on mental health benefits that are not imposed on substantially all medical and surgical benefits. The provisions of the Mental Health Parity Act are effective with respect to plan years beginning on or after January 1, 1998, and expire with respect to benefits for services furnished on or after December 31, 2003.[407]

The Taxpayer Relief Act of 1997 added to the Internal Revenue Code the requirements imposed under the Mental Health Parity Act, and imposed an excise tax on group health plans that fail to meet the requirements. The excise tax is equal to $100 per day during the period of noncompliance and is generally imposed on the employer sponsoring the plan if the plan fails to meet the requirements. The maximum tax that can be imposed during a taxable year cannot exceed the lesser of 10 percent of the employer's group health plan expenses for the prior year or $500,000. No tax is imposed if the Secretary determines that the employer did not know, and exercising reasonable diligence would not have known, that the failure existed.

The excise tax is applicable with respect to plan years beginning on or after January 1, 1998, and expires with respect to benefits for services provided on or after December 31, 2003.[408]

House Bill

No provision.

Senate Amendment

The Senate amendment extends the excise tax for failures to comply with mental health parity requirements through December 31, 2004.

Effective date.–The Senate amendment is effective for plan years beginning after December 31, 2002.

---

[407] Since enactment, the mental health parity requirements have been extended on more than one occasion.

[408] The excise tax does not apply to benefits for services furnished on or after September 30, 2001, and before January 10, 2002.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

B. Extend Alternative Minimum Tax Relief for Individuals (sec. 802 of the Senate amendment and sec. 26 of the Code)

Present Law

Present law provides for certain nonrefundable personal tax credits (i.e., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child tax credit,[409] the credit for interest on certain home mortgages, the HOPE Scholarship and Lifetime Learning credits, the IRA credit, and the D.C. homebuyer's credit).

For taxable years beginning in 2003, all the nonrefundable personal credits are allowed to the extent of the full amount of the individual's regular tax and alternative minimum tax.

Without an extension of these rules for taxable years beginning after 2003, these credits (other than the adoption credit, child credit and IRA credit) would be allowed only to the extent that the individual's regular income tax liability exceeds the individual's tentative minimum tax, determined without regard to the minimum tax foreign tax credit. The adoption credit, child credit, and IRA credit are allowed to the full extent of the individual's regular tax and alternative minimum tax.

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) $45,000 ($49,000 in taxable years beginning before 2005) in the case of married individuals filing a joint return and surviving spouses; (2) $33,750 ($35,750 in taxable years beginning before 2005) in the case of other unmarried individuals; (3) $22,500 ($24,500 in taxable years beginning before 2005) 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.

House Bill

No provision.

---

[409] A portion of the child credit may be refundable.

Senate Amendment

The Senate amendment provision extends the provisions allowing an individual to offset the entire regular tax liability and alternative minimum tax liability by the personal nonrefundable credits for one year.

Effective date.–The Senate amendment provision is effective for taxable years beginning after December 31, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

C. Extension of Electricity Production Credit for Electricity Produced from Certain Renewable Resources (sec. 803 of the Senate amendment and sec. 45 of the Code)

Present Law

An income tax credit is allowed for the production of electricity from either qualified wind energy, qualified "closed-loop" biomass, or qualified poultry waste facilities (sec. 45). The amount of the credit is 1.5 cents per kilowatt hour (indexed for inflation) of electricity produced.[410] The credit is allowable for production during the 10-year period after a facility is originally placed in service.

The credit applies to electricity produced by a wind energy facility placed in service after December 31, 1993, and before January 1, 2004, to electricity produced by a closed-loop biomass facility placed in service after December 31, 1992, and before January 1, 2004, and to a poultry waste facility placed in service after December 31, 1999, and before January 1, 2004.

House Bill

No provision.

Senate Amendment

The Senate amendment extends the placed in service date for qualified facilities from facilities placed in service before January 1, 2004 to facilities placed in service before January 1, 2005.

Effective date.–The Senate amendment provision is effective for property placed in service after December 31, 2002.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

[410] The amount of the credit is 1.8 cents per kilowatt hour for 2002.

D. Extend the Work Opportunity Tax Credit
(sec. 804 of the Senate amendment and sec. 51 of the Code)

Present Law

In general

The work opportunity tax credit ("WOTC") is available on an elective basis for employers hiring individuals from one or more of eight targeted groups. The credit equals 40 percent (25 percent for employment of less than 400 hours) of qualified wages. Generally, qualified wages are wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer.

The maximum credit per employee is $2,400 (40 percent of the first $6,000 of qualified first-year wages). With respect to qualified summer youth employees, the maximum credit is $1,200 (40 percent of the first $3,000 of qualified first-year wages).

For purposes of the credit, wages are generally defined as under the Federal Unemployment Tax Act, without regard to the dollar cap.

Targeted groups eligible for the credit

The eight targeted groups are: (1) families eligible to receive benefits under the Temporary Assistance for Needy Families ("TANF") Program; (2) high-risk youth; (3) qualified ex-felons; (4) vocational rehabilitation referrals; (5) qualified summer youth employees; (6) qualified veterans; (7) families receiving food stamps; and (8) persons receiving certain Supplemental Security Income ("SSI") benefits.

The employer's deduction for wages is reduced by the amount of the credit.

Expiration date

The credit is effective for wages paid or incurred to a qualified individual who begins work for an employer before January 1, 2004.

House Bill

No provision.

Senate Amendment

The Senate amendment extends the work opportunity tax credit for one year (through December 31, 2004).

Effective date.–The provision is effective for wages paid or incurred to a qualified individual who begins work for an employer on or after January 1, 2004, and before January 1, 2005.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

E. Extend the Welfare-To-Work Tax Credit
(sec. 805 of the Senate amendment and sec. 51A of the Code)

Present Law

In general

The welfare-to-work tax credit is available on an elective basis for employers for the first $20,000 of eligible wages paid to qualified long-term family assistance recipients during the first two years of employment. The credit is 35 percent of the first $10,000 of eligible wages in the first year of employment and 50 percent of the first $10,000 of eligible wages in the second year of employment. The maximum credit is $8,500 per qualified employee.

Qualified long-term family assistance recipients are: (1) members of a family that has received family assistance for at least 18 consecutive months ending on the hiring date; (2) members of a family that has received family assistance for a total of at least 18 months (whether or not consecutive) after the date of enactment of this credit if they are hired within 2 years after the date that the 18-month total is reached; and (3) members of a family that is no longer eligible for family assistance because of either Federal or State time limits, if they are hired within two years after the Federal or State time limits made the family ineligible for family assistance. Family assistance means benefits under the Temporary Assistance to Needy Families ("TANF") program.

For purposes of the credit, wages are generally defined under the Federal Unemployment Tax Act, without regard to the dollar amount. In addition, wages include the following: (1) educational assistance excludable under a section 127 program; (2) the value of excludable health plan coverage but not more than the applicable premium defined under section 4980B(f)(4); and (3) dependent care assistance excludable under section 129.

The employer's deduction for wages is reduced by the amount of the credit.

Expiration date

The welfare to work credit is effective for wages paid or incurred to a qualified individual who begins work for an employer before January 1, 2004.

House Bill

No provision.

Senate Amendment

The Senate amendment extends the welfare-to-work tax credit for one year (through December 31, 2004).

Effective date.–The provision is effective for wages paid or incurred to a qualified individual who begins work for an employer on or after January 1, 2004, and before January 1, 2005.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

F. Taxable Income Limit on Percentage Depletion for Oil and Natural Gas Produced from Marginal Properties (sec. 806 of the Senate amendment and sec. 613A of the Code)

Present Law

In general

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

Two methods of depletion are allowable under the Code: (1) the cost depletion method, and (2) the percentage depletion method (secs. 611-613). Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the depletable property which is equal to the ratio of units sold from that property during the taxable year to the number of units remaining as of the end of taxable year plus the number of units sold during the taxable year. Thus, the amount recovered under cost depletion may never exceed the taxpayer's basis in the property.

Under the percentage depletion method, generally, 15 percent of the taxpayer's gross income from an oil- or gas-producing property is allowed as a deduction in each taxable year (section 613A(c)). The amount deducted generally may not exceed 100 percent of the net income from that property in any year (the "net-income limitation") (section 613(a)). The 100-percent-of-net-income limitation for production from marginal wells has been suspended for taxable years beginning after December 31, 1997, and before January 1, 2004. Additionally, the percentage depletion deduction for all oil and gas properties may not exceed 65 percent of the taxpayer's overall taxable income (determined before such deduction and adjusted for certain loss carrybacks and trust distributions) (section 613A(d)(1)).[411] Because percentage depletion, unlike cost depletion, is computed without regard to the taxpayer's basis in the depletable property, cumulative depletion deductions may be greater than the amount expended by the taxpayer to acquire or develop the property.

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

---

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

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

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

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

House Bill

No provision.

Senate Amendment

The Senate amendment extends for an additional year the suspension of the 100-percent net-income limit for marginal wells to include taxable years beginning after December 31, 2003 and before January 1, 2005.

Effective date.–The Senate amendment provision is effective for taxable years beginning after December 31, 2002.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

G. Qualified Zone Academy Bonds
(sec. 807 of the Senate amendment and sec. 1397E of the Code)

Present Law

Tax-exempt bonds

Interest on State and local governmental bonds generally is excluded from gross income for Federal income tax purposes if the proceeds of the bonds are used to finance direct activities of these governmental units or if the bonds are repaid with revenues of the governmental units. Activities that can be financed with these tax-exempt bonds include the financing of public schools (sec. 103).

Qualified zone academy bonds

As an alternative to traditional tax-exempt bonds, States and local governments are given the authority to issue "qualified zone academy bonds" ("QZABs") (sec. 1397E). A total of $400 million of qualified zone academy bonds may be issued annually in calendar years 1998 through 2003. The $400 million aggregate bond cap is allocated each year to the States according to their respective populations of individuals below the poverty line. Each State, in turn, allocates the credit authority to qualified zone academies within such State.

Financial institutions that hold qualified zone academy bonds are entitled to a nonrefundable tax credit in an amount equal to a credit rate multiplied by the face amount of the bond. A taxpayer holding a qualified zone academy bond on the credit allowance date is entitled to a credit. The credit is includable in gross income (as if it were a taxable interest payment on the bond), and may be claimed against regular income tax and AMT liability.

The Treasury Department sets the credit rate at a rate estimated to allow issuance of qualified zone academy bonds without discount and without interest cost to the issuer. The maximum term of the bond is determined by the Treasury Department, so that the present value of the obligation to repay the bond is 50 percent of the face value of the bond.

"Qualified zone academy bonds" are defined as any bond issued by a State or local government, provided that: (1) at least 95 percent of the proceeds are used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a "qualified zone academy", and (2) private entities have promised to contribute to the qualified zone academy certain equipment, technical assistance or training, employee services, or other property or services with a value equal to at least 10 percent of the bond proceeds.

A school is a "qualified zone academy" if: (1) the school is a public school that provides education and training below the college level, (2) the school operates a special academic program in cooperation with businesses to enhance the academic curriculum and increase graduation and employment rates, and (3) either (a) the school is located in an empowerment zone or enterprise community designated under the Code, or (b) it is reasonably expected that at

least 35 percent of the students at the school will be eligible for free or reduced-cost lunches under the school lunch program established under the National School Lunch Act.

House Bill

No provision.

Senate Amendment

The Senate amendment authorizes issuance of up to $400 million of qualified zone academy bonds for calendar year 2004.

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

Conference Agreement

The conference agreement does not include the Senate amendment provision.

H. Cover Over of Tax on Distilled Spirits
(sec. 808 of the Senate amendment and sec. 7652(e) of the Code)

Present Law

A $13.50 per proof gallon[412] excise tax is imposed on distilled spirits produced in or imported (or brought) into the United States. The excise tax does not apply to distilled spirits that are exported from the United States or to distilled spirits that are consumed in U.S. possessions (e.g., Puerto Rico and the Virgin Islands).

The Code provides for coverover (payment) of $13.25 per proof gallon of the excise tax imposed on rum imported (or brought) into the United States (without regard to the country of origin) to Puerto Rico and the Virgin Islands during the period July 1, 1999 through December 31, 2003. Effective on January 1, 2004, the coverover rate is scheduled to return to its permanent level of $10.50 per proof gallon.

Amounts covered over to Puerto Rico and the Virgin Islands are deposited into the treasuries of the two possessions for use as those possessions determine.

House Bill

No provision.

Senate Amendment

The Senate amendment extends the $13.25-per-proof-gallon coverover rate for one additional year, through December 31, 2004.

Effective date.–The Senate amendment provision is effective for articles brought into the United States after December 31, 2002.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

[412] A proof of gallon is a liquid gallon consisting of 50 percent alcohol.

I. Extend Deduction for Corporate Donations of Computer Technology (sec. 809 of the Senate amendment and sec. 170 of the Code)

Present Law

In the case of a charitable contribution of inventory or other ordinary-income or short-term capital gain property, the amount of the charitable deduction generally is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose. In cases involving contributions to a private foundation (other than certain private operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property.[413]

Under present law, a taxpayer's deduction for charitable contributions of scientific property used for research and for contributions of computer technology and equipment generally is limited to the taxpayer's basis (typically, cost) in the property. However, certain corporations may claim a deduction in excess of basis for a "qualified research contribution" or a "qualified computer contribution."[414] This enhanced deduction is equal to the lesser of (1) basis plus one-half of the item's appreciated value (i.e., basis plus one half of fair market value minus basis) or (2) two times basis.

A qualified computer contribution means a charitable contribution by a corporation of any computer technology or equipment, which meets standards of functionality and suitability as established by the Secretary of the Treasury. The contribution must be to certain educational organizations or public libraries and made not later than three years after the taxpayer acquired the property or, if the taxpayer constructed the property, not later than the date construction of the property is substantially completed.[415] The original use of the property must be by the donor or the donee,[416] and in the case of the donee, must be used substantially for educational purposes related to the function or purpose of the donee. The property must fit productively into the donee's education plan. The donee may not transfer the property in exchange for money, other property, or services, except for shipping, installation, and transfer costs. To determine whether property is constructed by the taxpayer, the rules applicable to qualified research contributions apply. That is, property is considered constructed by the taxpayer only if the cost of the parts used in the construction of the property (other than parts manufactured by the taxpayer or a

---

[413] Sec. 170(e)(1).

[414] Secs. 170(e)(4) and 170(e)(6).

[415] If the taxpayer constructed the property and reacquired such property, the contribution must be within three years of the date the original construction was substantially completed. Sec. 170(e)(6)(D)(i).

[416] This requirement does not apply if the property was reacquired by the manufacturer and contributed. Sec. 170(e)(6)(D)(ii).

related person) does not exceed 50 percent of the taxpayer's basis in the property. Contributions may be made to private foundations under certain conditions.[417]

The enhanced deduction for qualified computer contributions expires for any contribution made during any taxable year beginning after December 31, 2003.

House Bill

No provision.

Senate Amendment

The Senate amendment provision extends the enhanced deduction for qualified computer contributions to apply to contributions made during taxable years beginning on or before December 31, 2004.

Effective date.–The Senate amendment provision is effective for contributions made after December 31, 2002.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

[417] Sec. 170(e)(6)(C).

J. Extension of Credit for Electric Vehicles
(sec. 810 of the Senate amendment and sec. 30 of the Code)

Present Law

A 10-percent tax credit is provided for the cost of a qualified electric vehicle, up to a maximum credit of $4,000 (sec. 30). A qualified electric vehicle is a motor vehicle that is powered primarily by an electric motor drawing current from rechargeable batteries, fuel cells, or other portable sources of electrical current, the original use of which commences with the taxpayer, and that is acquired for the use by the taxpayer and not for resale. The full amount of the credit is available for purchases prior to 2004. The credit phases down in the years 2004 through 2006, and is unavailable for purchases after December 31, 2006.

House Bill

No provision.

Senate Amendment

The Senate amendment delays the beginning of the phase out of the credit by one year and provides that the credit is available for purchases through December 31, 2007.

Effective date.–The Senate amendment provision is effective for property placed in service after December 31, 2002.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

K. Extension of Deduction for Clean-Fuel Vehicles and Clean-Fuel Vehicle Refueling Property (sec. 811 of the Senate amendment and sec. 179A of the Code)

Present Law

Clean-fuel vehicles

Certain costs of qualified clean-fuel vehicle may be expensed and deducted when such property is placed in service (sec. 179A). Qualified clean-fuel vehicle property includes motor vehicles that use certain clean-burning fuels (natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, electricity and any other fuel at least 85 percent of which is methanol, ethanol, any other alcohol or ether). The maximum amount of the deduction is $50,000 for a truck or van with a gross vehicle weight over 26,000 pounds or a bus with seating capacities of at least 20 adults; $5,000 in the case of a truck or van with a gross vehicle weight between 10,000 and 26,000 pounds; and $2,000 in the case of any other motor vehicle. Qualified electric vehicles do not qualify for the clean-fuel vehicle deduction. The deduction phases down in the years 2004 through 2006, and is unavailable for purchases after December 31, 2006.

Clean-fuel vehicle refueling property

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

House Bill

No provision.

Senate Amendment

The Senate amendment delays the beginning of the phase down of the deduction for qualified clean-fuel vehicle property by one year and provides that the deduction is available through December 31, 2007. The Senate amendment extends the deduction for clean-fuel vehicle refueling property by one year to include equipment placed in service prior to January 1, 2008.

Effective date.–The Senate amendment provision is effective for property placed in service after December 31, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

L. Adjusted Gross Income Determined by Taking into Account Certain Expenses of Elementary and Secondary School Teachers (sec. 812 of the Senate amendment and sec. 62 of the Code)

Present Law

In general, ordinary and necessary business expenses are deductible (sec. 162), and unreimbursed employee business expenses are deductible only as an itemized deduction and only to the extent that the individual's total miscellaneous deductions (including employee business expenses) exceed two percent of adjusted gross income.

However, an above-the-line deduction is allowed for taxable years beginning in 2002 and 2003 for up to $250 annually of expenses paid or incurred by an eligible educator for books, supplies (other than nonathletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services) and other equipment, and supplementary materials used by the eligible educator in the classroom. To be eligible for this deduction, the expenses must be otherwise deductible under section 162 as a trade or business expense. A deduction is allowed only to the extent the amount of expenses exceeds the amount of such expenses excludable from income under section 135 (relating to education savings bonds), section 529(c)(1) (relating to qualified tuition programs), and section 530(d)(2) (relating to Coverdell education savings accounts).

An eligible educator is a kindergarten through grade 12 teacher, instructor, counselor, principal, or aide in a school for at least 900 hours during a school year. A school means any school that provides elementary education or secondary education, as determined under State law.

An individual's otherwise allowable itemized deductions may be further limited by the overall limitation on itemized deductions, which reduces itemized deductions for taxpayers with adjusted gross income in excess of $139,500 (for 2003).[418] In addition, miscellaneous itemized deductions are not allowable under the alternative minimum tax.

House Bill

No provision.

Senate Amendment

The Senate amendment extends the present-law above-the-line deduction for eligible educators to include taxable years beginning in 2004.

Effective date.–The Senate amendment provision is effective for taxable years beginning after December 31, 2002.

---

[418] The effect of this overall limitation is phased down beginning in 2006.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

M. Extend Archer Medical Savings Accounts ("MSAs") (sec. 813 of the Senate amendment and sec. 220 of the Code)

Present Law

In general

Within limits, contributions to an Archer MSA are deductible in determining adjusted gross income if made by an eligible individual and are excludable from gross income and wages for employment tax purposes if made by the employer of an eligible individual. Earnings on amounts in an Archer MSA are not currently taxable. Distributions from an Archer MSA for medical expenses are not includible in gross income. Distributions not used for medical expenses are includible in gross income. In addition, distributions not used for medical expenses are subject to an additional 15-percent tax unless the distribution is made after age 65, death, or disability.

Eligible individuals

Archer MSAs are available to employees covered under an employer-sponsored high deductible plan of a small employer and self-employed individuals covered under a high deductible health plan.[419] An employer is a small employer if it employed, on average, no more than 50 employees on business days during either the preceding or the second preceding year. An individual is not eligible for an Archer MSA if he or she is covered under any other health plan in addition to the high deductible plan.

Tax treatment of and limits on contributions

Individual contributions to an Archer MSA are deductible (within limits) in determining adjusted gross income (i.e., "above-the-line"). In addition, employer contributions are excludable from gross income and wages for employment tax purposes (within the same limits), except that this exclusion does not apply to contributions made through a cafeteria plan. In the case of an employee, contributions can be made to an Archer MSA either by the individual or by the individual's employer.

The maximum annual contribution that can be made to an Archer MSA for a year is 65 percent of the deductible under the high deductible plan in the case of individual coverage and 75 percent of the deductible in the case of family coverage.

Definition of high deductible plan

A high deductible plan is a health plan with an annual deductible of at least $1,700 and no more than $2,500 in the case of individual coverage and at least $3,350 and no more than

---

[419] Self-employed individuals include more than two-percent shareholders of S corporations who are treated as partners for purposes of fringe benefit rules pursuant to section 1372.

$5,050 in the case of family coverage. In addition, the maximum out-of-pocket expenses with respect to allowed costs (including the deductible) must be no more than $3,350 in the case of individual coverage and no more than $6,150 in the case of family coverage.[420] A plan does not fail to qualify as a high deductible plan merely because it does not have a deductible for preventive care as required by State law. A plan does not qualify as a high deductible health plan if substantially all of the coverage under the plan is for permitted coverage (as described above). In the case of a self-insured plan, the plan must in fact be insurance (e.g., there must be appropriate risk shifting) and not merely a reimbursement arrangement.

Cap on taxpayers utilizing Archer MSAs and expiration of pilot program

The number of taxpayers benefiting annually from an Archer MSA contribution is limited to a threshold level (generally 750,000 taxpayers). The number of Archer MSAs established has not exceeded the threshold level.

After 2003, no new contributions may be made to Archer MSAs except by or on behalf of individuals who previously had Archer MSA contributions and employees who are employed by a participating employer.

House Bill

No provision.

Senate Amendment

The Senate amendment extends Archer MSAs through December 31, 2004.

Effective date.–The Senate amendment provision is effective on January 1, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

[420] These dollar amounts are for 2003. These amounts are indexed for inflation in $50 increments.

N. Extension of Expensing of Brownfield Remediation Expenses (sec. 814 of the Senate amendment and sec. 198 of the Code)

Present Law

Under Code section 198, taxpayers can elect to treat certain environmental remediation expenditures that would otherwise be chargeable to capital account as deductible in the year paid or incurred. The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site. In general, any expenditure for the acquisition of depreciable property used in connection with the abatement or control of hazardous substances at a qualified contaminated site does not constitute a qualified environmental remediation expenditure. However, depreciation deductions allowable for such property, which would otherwise be allocated to the site under the principles set forth in *Commissioner v. Idaho Power Co.*[421] and section 263A, are treated as qualified environmental remediation expenditures.

A "qualified contaminated site" (a so-called "brownfield") generally is any property that is held for use in a trade or business, for the production of income, or as inventory and is certified by the appropriate State environmental agency to be an area at or on which there has been a release (or threat of release) or disposal of a hazardous substance. Both urban and rural property may qualify. However, sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 ("CERCLA") cannot qualify as targeted areas. Hazardous substances generally are defined by reference to sections 101(14) and 102 of CERCLA, subject to additional limitations applicable to asbestos and similar substances within buildings, certain naturally occurring substances such as radon, and certain other substances released into drinking water supplies due to deterioration through ordinary use.

Eligible expenditures are those paid or incurred before January 1, 2004.

House Bill

No provision.

Senate Amendment

The Senate amendment extends by one year the present-law deduction for environmental remediation expenditures to include expenditures incurred prior to January 1, 2005.

Effective date.–The Senate amendment provision is effective for expenditures incurred after December 31, 2002.

---

[421] *Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974) (holding that equipment depreciation allocable to the taxpayer's construction of capital facilities must be capitalized under section 263(a)(1)).

Conference Agreement

The conference agreement does not include the Senate amendment provision.

XI. IMPROVING TAX EQUITY FOR MILITARY PERSONNEL

A. Exclusion of Gain on Sale of a Principal Residence by a Member of the Uniformed Services or the Foreign Service (sec. 901 of the Senate amendment and sec. 121 of the Code)

Present Law

Under present law, an individual taxpayer may exclude up to $250,000 ($500,000, if married filing a joint return) of gain realized on the sale or exchange of a principal residence. To be eligible for the exclusion, the taxpayer must have owned and used the residence as a principal residence for at least two of the five years ending on the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or, to the extent provided under regulations, unforeseen circumstances is able to exclude an amount equal to the fraction of the $250,000 ($500,000 if married filing a joint return) that is equal to the fraction of the two years that the ownership and use requirements are met. There are no special rules relating to members of the uniformed services or the Foreign Service of the United States.

House Bill

No provision.

Senate Amendment

Under the Senate amendment, an individual may elect to suspend for a maximum of ten years the five-year test period for ownership and use during certain absences due to service in the uniformed services, or the Foreign Service of the United States. The uniformed services include: (1) the Armed forces (the Army, Navy, Air Force, Marine Corps, and Coast Guard); (2) the commissioned corps of the National Oceanic and Atmospheric Administration; and (3) the commissioned corps of the Public Health Service. If the election is made, the five-year period ending on the date of the sale or exchange of a principal residence does not include any period up to ten years during which the taxpayer or the taxpayer's spouse is on qualified official extended duty as a member of the uniformed services, or in the Foreign Service of the United States. For these purposes, qualified official extended duty is any period of extended duty by a member of the uniformed services, or the Foreign Service of the United States while serving at a place of duty at least 50 miles away from the taxpayer's principal residence or under orders compelling residence in Government furnished quarters. Extended duty is defined as any period of duty pursuant to a call or order to such duty for a period in excess of 90 days or for an indefinite period. The election may be made with respect to only one property for a suspension period.

Effective date.–The Senate amendment provision is effective for sales or exchanges after May 6, 1997.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

B. Exclusion from Gross Income of Certain Death Gratuity Payments (sec. 902 of the Senate amendment and sec. 134 of the Code)

Present Law

Present law provides that qualified military benefits are not included in gross income. Generally, a qualified military benefit is any allowance or in-kind benefit (other than personal use of a vehicle) which: (1) is received by any member or former member of the uniformed services of the United States or any dependent of such member by reason of such member's status or service as a member of such uniformed services; and (2) was excludable from gross income on September 9, 1986, under any provision of law, regulation, or administrative practice which was in effect on such date. Generally, other than certain cost of living adjustments, no modification or adjustment of any qualified military benefit after September 9, 1986, is taken into account for purposes of this exclusion from gross income. Qualified military benefits include certain death gratuities. The amount of the death gratuity military benefit was increased to $6,000 but the amount of the exclusion from gross income was not increased to take into account this change.

House Bill

No provision.

Senate Amendment

The Senate amendment extends the exclusion from gross income to any adjustment to the amount of the death gratuity payable under Chapter 75 of Title 10 of the United States Code that is pursuant to a provision of law with respect to the death of certain members of the Armed services on active duty, inactive duty training, or engaged in authorized travel. Therefore, the amount of the exclusion is increased to $6,000.

Effective date.–The Senate amendment provision is effective with respect to deaths occurring after September 10, 2001.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

C. Exclusion for Amounts Received Under Department of Defense Homeowners Assistance Program (sec. 903 of the Senate amendment and sec. 132 of the Code)

Present Law

HAP payment

The Department of Defense Homeowners Assistance Program ("HAP") provides payments to certain employees and members of the Armed Forces to offset the adverse effects on housing values that result from a military base realignment or closure. The payments are authorized under the provisions of Title 42 U.S.C. section 3374.

In general, under HAP, eligible individuals receive either (1) a cash payment as compensation for losses that may be or have been sustained in a private sale, in an amount not to exceed the difference between (a) 95 percent of the fair market value of their property prior to public announcement of intention to close all or part of the military base or installation and (b) the fair market value of such property at the time of the sale, or (2) as the purchase price for their property, an amount not to exceed 90 percent of the prior fair market value as determined by the Secretary of Defense, or the amount of the outstanding mortgages.

Tax treatment

Unless specifically excluded, gross income for Federal income tax purposes includes all income from whatever source derived. Amounts received under HAP are received in connection with the performance of services. These amounts are includible in gross income as compensation for services to the extent such payments exceed the fair market value of the property relinquished in exchange for such payments. Additionally, such payments are wages for Federal Insurance Contributions Act ("FICA") tax purposes (including Medicare).

House Bill

No provision.

Senate Amendment

The Senate amendment generally exempts from gross income amounts received under the HAP (as in effect on the date of enactment of this Senate amendment). Amounts received under the program also are not considered wages for FICA tax purposes (including Medicare). The excludable amount is limited to the reduction in the fair market value of property.

Effective date.–The Senate amendment provision is effective for payments made after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

D. Expansion of Combat Zone Filing Rules to Contingency Operations (sec. 904 of the Senate amendment and sec. 7508 of the Code)

Present Law

General time limits for filing tax returns

Individuals generally must file their Federal income tax returns by April 15 of the year following the close of a taxable year. The Secretary may grant reasonable extensions of time for filing such returns. Treasury regulations provide an additional automatic two-month extension (until June 15 for calendar-year individuals) for United States citizens and residents in military or naval service on duty on April 15 of the following year (the otherwise applicable due date of the return) outside the United States. No action is necessary to apply for this extension, but taxpayers must indicate on their returns (when filed) that they are claiming this extension. Unlike most extensions of time to file, this extension applies to both filing returns and paying the tax due.

Treasury regulations also provide, upon application on the proper form, an automatic four-month extension (until August 15 for calendar-year individuals) for any individual timely filing that form and paying the amount of tax estimated to be due.

In general, individuals must make quarterly estimated tax payments by April 15, June 15, September 15, and January 15 of the following taxable year. Wage withholding is considered to be a payment of estimated taxes.

Suspension of time periods

In general, the period of time for performing various acts under the Code, such as filing tax returns, paying taxes, or filing a claim for credit or refund of tax, is suspended for any individual serving in the Armed Forces of the United States in an area designated as a "combat zone" during the period of combatant activities. An individual who becomes a prisoner of war is considered to continue in active service and is therefore also eligible for these suspension of time provisions. The suspension of time also applies to an individual serving in support of such Armed Forces in the combat zone, such as Red Cross personnel, accredited correspondents, and civilian personnel acting under the direction of the Armed Forces in support of those Forces. The designation of a combat zone must be made by the President in an Executive Order. The President must also designate the period of combatant activities in the combat zone (the starting date and the termination date of combat).

The suspension of time encompasses the period of service in the combat zone during the period of combatant activities in the zone, as well as (1) any time of continuous qualified hospitalization resulting from injury received in the combat zone[422] or (2) time in missing in action status, plus the next 180 days.

---

[422] Two special rules apply to continuous hospitalization inside the United States. First, the suspension of time provisions based on continuous hospitalization inside the United States are applicable only to the hospitalized individual; they are not applicable to the spouse of such

The suspension of time applies to the following acts:

(1) Filing any return of income, estate, or gift tax (except employment and withholding taxes);

(2) Payment of any income, estate, or gift tax (except employment and withholding taxes);

(3) Filing a petition with the Tax Court for redetermination of a deficiency, or for review of a decision rendered by the Tax Court;

(4) Allowance of a credit or refund of any tax;

(5) Filing a claim for credit or refund of any tax;

(6) Bringing suit upon any such claim for credit or refund;

(7) Assessment of any tax;

(8) Giving or making any notice or demand for the payment of any tax, or with respect to any liability to the United States in respect of any tax;

(9) Collection of the amount of any liability in respect of any tax;

(10) Bringing suit by the United States in respect of any liability in respect of any tax; and

(11) Any other act required or permitted under the internal revenue laws specified by the Secretary of the Treasury.

Individuals may, if they choose, perform any of these acts during the period of suspension. Spouses of qualifying individuals are entitled to the same suspension of time, except that the spouse is ineligible for this suspension for any taxable year beginning more than two years after the date of termination of combatant activities in the combat zone.

House Bill

No provision.

Senate Amendment

The Senate amendment applies the special suspension of time period rules to persons deployed outside the United States away from the individual's permanent duty station while

---

individual. Second, in no event do the suspension of time provisions based on continuous hospitalization inside the United States extend beyond five years from the date the individual returns to the United States. These two special rules do not apply to continuous hospitalization outside the United States.

participating in an operation designated by the Secretary of Defense as a contingency operation or that becomes a contingency operation. A contingency operation is defined[423] as a military operation that is designated by the Secretary of Defense as an operation in which members of the Armed Forces are or may become involved in military actions, operations, or hostilities against an enemy of the United States or against an opposing military force, or results in the call or order to (or retention of) active duty of members of the uniformed services during a war or a national emergency declared by the President or Congress.

Effective date.–The Senate amendment provision applies to any period for performing an act that has not expired before the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

E. Modification of Membership Requirement for Exemption from Tax for Certain Veterans' Organizations (sec. 905 of the Senate amendment and sec. 501 of the Code)

Present Law

Under present law, a veterans' organization as described in section 501(c)(19) of the Code generally is exempt from taxation. The Code defines such an organization as a post or organization of past or present members of the Armed Forces of the United States: (1) that is organized in the United States or any of its possessions; (2) no part of the net earnings of which inures to the benefit of any private shareholder or individual; and (3) that meets certain membership requirements. The membership requirements are that (1) at least 75 percent of the organization's members are past or present members of the Armed Forces of the United States, and (2) substantially all of the remaining members are cadets or are spouses, widows, or widowers of past or present members of the Armed Forces of the United States or of cadets. No more than 2.5 percent of an organization's total members may consist of individuals who are not veterans, cadets, or spouses, widows, or widowers of such individuals.

Contributions to an organization described in section 501(c)(19) may be deductible for Federal income or gift tax purposes if the organization is a post or organization of war veterans.

House Bill

No provision.

Senate Amendment

The Senate amendment permits ancestors or lineal descendants of past or present members of the Armed Forces of the United States or of cadets to qualify as members for purposes of the "substantially all" test. The Senate amendment does not change the requirement

[423] The definition is by cross-reference to 10 U.S.C. 101.

that 75 percent of the organization's members must be past or present members of the Armed Forces of the United States.

Effective date.–The Senate amendment provision is effective for taxable years beginning after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

F. Clarification of Treatment of Certain Dependent Care Assistance Programs Provided to Members of the Uniformed Services of the United States (sec. 906 of the Senate amendment and sec. 134 of the Code)

Present Law

Present law provides that qualified military benefits are not included in gross income. Generally, a qualified military benefit is any allowance or in-kind benefit (other than personal use of a vehicle) which: (1) is received by any member or former member of the uniformed services of the United States or any dependent of such member by reason of such member's status or service as a member of such uniformed services; and (2) was excludable from gross income on September 9, 1986, under any provision of law, regulation, or administrative practice which was in effect on such date. Generally, other than certain cost of living adjustments, no modification or adjustment of any qualified military benefit after September 9, 1986, is taken into account for purposes of this exclusion from gross income.

House Bill

No provision.

Senate Amendment

The Senate amendment clarifies that dependent care assistance provided under a dependent care assistance program (as in effect on the date of enactment of this Senate amendment) for a member of the uniformed services by reason of such member's status or service as a member of the uniformed services is excludable from gross income as a qualified military benefit subject to the present-law rules. The uniformed services include: (1) the Armed Forces (the Army, Navy, Air Force, Marine Corps, and Coast Guard); (2) the commissioned corps of the National Oceanic and Atmospheric Administration; and (3) the commissioned corps of the Public Health Service. Amounts received under the program also are not considered wages for Federal Insurance Contributions Act tax purposes (including Medicare).

Effective date.–The Senate amendment provision is effective for taxable years beginning after December 31, 2002. No inference is intended as to the tax treatment of such amounts for prior taxable years.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

G. Treatment of Service Academy Appointments as Scholarships for Purposes of Qualified Tuition Programs and Coverdell Education Savings Accounts (sec. 907 of the Senate amendment and secs. 529 and 530 of the Code)

Present Law

The Code provides tax-exempt status to qualified tuition programs, meaning programs established and maintained by a State or agency or instrumentality thereof or by one or more eligible educational institutions under which a person (1) may purchase tuition credits or certificates on behalf of a designated beneficiary which entitle the beneficiary to the waiver or payment of qualified higher education expenses of the beneficiary, or (2) in the case of a program established by and maintained by a State or agency or instrumentality thereof, may make contributions to an account which is established for the purpose of meeting the qualified higher education expenses of the designated beneficiary of the account. Contributions to qualified tuition programs may be made only in cash. Qualified tuition programs must have adequate safeguards to prevent contributions on behalf of a designated beneficiary in excess of amounts necessary to provide for the qualified higher education expenses of the beneficiary.

The Code provides tax-exempt status to Coverdell education savings accounts ("ESAs"), meaning certain trusts or custodial accounts which are created or organized in the United States exclusively for the purpose of paying the qualified education expenses of a designated beneficiary. Contributions to ESAs may be made only in cash. Annual contributions to ESAs may not exceed $2,000 per beneficiary (except in cases involving certain tax-free rollovers) and may not be made after the designated beneficiary reaches age 18.

Earnings on contributions to an ESA or a qualified tuition program generally are subject to tax when withdrawn. However, distributions from an ESA or qualified tuition program are excludable from the gross income of the distributee to the extent that the total distribution does not exceed the qualified education expenses incurred by the beneficiary during the year the distribution is made.

If the qualified education expenses of the beneficiary for the year are less than the total amount of the distribution from an ESA or qualified tuition program, then the qualified education expenses are deemed to be paid from a pro-rata share of both the principal and earnings components of the distribution. In such a case, only a portion of the earnings is excludable (i.e., the portion of the earnings based on the ratio that the qualified education expenses bear to the total amount of the distribution) and the remaining portion of the earnings is includible in the beneficiary's gross income.

The earnings portion of a distribution from an ESA or a qualified tuition program that is includible in income is generally subject to an additional 10 percent tax. The 10 percent additional tax does not apply if a distribution is made on account of the death or disability of the designated beneficiary, or on account of a scholarship received by the designated beneficiary (to the extent it does not exceed the amount of the scholarship).

Service obligations are required of recipients of appointments to the United States Military Academy, the United States Naval Academy, the United States Air Force Academy, the United States Coast Guard Academy, or the United States Merchant Marine Academy. Because of these service obligations, appointments to the Academies are not considered scholarships for purposes of the waiver of the additional 10 percent tax on withdrawals from ESAs and qualified tuition programs that are not used for qualified education purposes.

House Bill

No provision.

Senate Amendment

The Senate amendment permits penalty-free withdrawals from Coverdell education savings accounts and qualified tuition programs made on account of the attendance of the beneficiary at the United States Military Academy, the United States Naval Academy, the United States Air Force Academy, the United States Coast Guard Academy, or the United States Merchant Marine Academy.

The amount of funds that can be withdrawn penalty free is limited to the costs of advanced education as defined in 10 United States Code section 2005(e)(3) (as in effect on the date of the enactment of the Senate amendment) at such Academies.

Effective date.–The Senate amendment provision applies to taxable years beginning after December 31, 2002.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

H. Suspension of Tax-Exempt Status of Designated Terrorist Organizations (sec. 908 of the Senate amendment and sec. 501 of the Code)

Present Law

Under present law, the Internal Revenue Service generally issues a letter revoking recognition of an organization's tax-exempt status only after (1) conducting an examination of the organization, (2) issuing a letter to the organization proposing revocation, and (3) allowing the organization to exhaust the administrative appeal rights that follow the issuance of the proposed revocation letter. In the case of an organization described in section 501(c)(3), the revocation letter immediately is subject to judicial review under the declaratory judgment procedures of section 7428. To sustain a revocation of tax-exempt status under section 7428, the IRS must demonstrate that the organization is no longer entitled to exemption. There is no procedure under current law for the IRS to suspend the tax-exempt status of an organization.

To combat terrorism, the Federal government has designated a number of organizations as terrorist organizations or supporters of terrorism under the Immigration and Nationality Act,

the International Emergency Economic Powers Act, and the United Nations Participation Act of 1945.

House Bill

No provision.

Senate Amendment

The Senate amendment provision suspends the tax-exempt status of an organization that is exempt from tax under section 501(a) for any period during which the organization is designated or identified by U.S. Federal authorities as a terrorist organization or supporter of terrorism. The provision also makes such an organization ineligible to apply for tax exemption under section 501(a). The period of suspension runs from the date the organization is first designated or identified (or from the date of enactment of the provision, whichever is later) to the date when all designations or identifications with respect to the organization have been rescinded pursuant to the law or Executive order under which the designation or identification was made.

The Senate amendment provision describes a terrorist organization as an organization that has been designated or otherwise individually identified (1) as a terrorist organization or foreign terrorist organization under the authority of section 212(a)(3)(B)(vi)(II) or section 219 of the Immigration and Nationality Act; (2) in or pursuant to an Executive order that is related to terrorism and issued under the authority of the International Emergency Economic Powers Act or section 5 of the United Nations Participation Act for the purpose of imposing on such organization an economic or other sanction; or (3) in or pursuant to an Executive order that refers to the provision and is issued under the authority of any Federal law if the organization is designated or otherwise individually identified in or pursuant to such Executive order as supporting or engaging in terrorist activity (as defined in section 212(a)(3)(B) of the Immigration and Nationality Act) or supporting terrorism (as defined in section 140(d)(2) of the Foreign Relations Authorization Act, Fiscal Years 1988 and 1989). During the period of suspension, no deduction for any contribution to a terrorist organization is allowed under the Code, including under sections 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522.

No organization or other person may challenge, under section 7428 or any other provision of law, in any administrative or judicial proceeding relating to the Federal tax liability of such organization or other person, the suspension of tax-exemption, the ineligibility to apply for tax-exemption, a designation or identification described above, the timing of the period of suspension, or a denial of deduction described above. The suspended organization may maintain other suits or administrative actions against the agency or agencies that designated or identified the organization, for the purpose of challenging such designation or identification (but not the suspension of tax-exempt status under this provision).

If the tax-exemption of an organization is suspended and each designation and identification that has been made with respect to the organization is determined to be erroneous pursuant to the law or Executive order making the designation or identification, and such erroneous designation results in an overpayment of income tax for any taxable year with respect to such organization, a credit or refund (with interest) with respect to such overpayment shall be

made. If the operation of any law or rule of law (including res judicata) prevents the credit or refund at any time, the credit or refund may nevertheless be allowed or made if the claim for such credit or refund is filed before the close of the one-year period beginning on the date that the last remaining designation or identification with respect to the organization is determined to be erroneous.

The Senate amendment provision directs the IRS to update the listings of tax-exempt organizations to take account of organizations that have had their exemption suspended and to publish notice to taxpayers of the suspension of an organization's tax-exemption and the fact that contributions to such organization are not deductible during the period of suspension.

Effective date.–The Senate amendment provision is effective for designations made before, on, or after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

I. Above-the-Line Deduction for Overnight Travel Expenses of National Guard and Reserve Members (sec. 909 of the Senate amendment and sec. 162 of the Code)

Present Law

National Guard and Reserve members may claim itemized deductions for their nonreimbursable expenses for transportation, meals, and lodging when they must travel away from home (and stay overnight) to attend National Guard and Reserve meetings. These overnight travel expenses are combined with other miscellaneous itemized deductions on Schedule A of the individual's income tax return and are deductible only to the extent that the aggregate of these deductions exceeds two percent of the taxpayer's adjusted gross income. No deduction is generally permitted for commuting expenses to and from drill meetings.

House Bill

No provision.

Senate Amendment

The Senate amendment provides an above-the-line deduction for the overnight transportation, meals, and lodging expenses of National Guard and Reserve members who must travel away from home more than 100 miles (and stay overnight) to attend National Guard and Reserve meetings. Accordingly, these individuals incurring these expenses can deduct them from gross income regardless of whether they itemize their deductions. The amount of the expenses that may be deducted may not exceed the general Federal Government per diem rate applicable to that locale.

Effective date.–The Senate amendment provision is effective with respect to amounts paid or incurred after December 31, 2002.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

J. Extension of Certain Tax Relief Provisions to Astronauts (sec. 910 of the Senate amendment and secs. 101, 692, and 2201 of the Code)

Present Law

In general

The Victims of Terrorism Tax Relief Act of 2001 (the "Victims Act") provided certain income and estate tax relief to individuals who die from wounds or injury incurred as a result of the terrorist attacks against the United States on September 11, 2001, and April 19, 1995 (the bombing of the Alfred P. Murrah Federal Building in Oklahoma City) or as a result of illness incurred due to an attack involving anthrax that occurred on or after September 11, 2001, and before January 1, 2002.

Income tax relief

The Victims Act extended relief similar to the present-law treatment of military or civilian employees of the United States who die as a result of terrorist or military activity outside the United States to individuals who die as a result of wounds or injury which were incurred as a result of the terrorist attacks that occurred on September 11, 2001, or April 19, 1995, and individuals who die as a result of illness incurred due to an attack involving anthrax that occurs on or after September 11, 2001, and before January 1, 2002. Under the Victims Act, such individuals generally are exempt from income tax for the year of death and for prior taxable years beginning with the taxable year prior to the taxable year in which the wounds or injury occurred.[424] The exemption applies to these individuals whether killed in an attack (e.g., in the case of the September 11, 2001, attack in one of the four airplanes or on the ground) or in rescue or recovery operations.

Present law provides a minimum tax relief benefit of $10,000 to each eligible individual regardless of the income tax liability of the individual for the eligible tax years. If an eligible individual's income tax for years eligible for the exclusion under the provision is less than $10,000, the individual is treated as having made a tax payment for such individual's last taxable year in an amount equal to the excess of $10,000 over the amount of tax not imposed under the provision.

Subject to rules prescribed by the Secretary, the exemption from tax does not apply to the tax attributable to (1) deferred compensation which would have been payable after death if the individual had died other than as a specified terrorist victim, or (2) amounts payable in the taxable year which would not have been payable in such taxable year but for an action taken after September 11, 2001. Thus, for example, the exemption does not apply to amounts payable from a qualified plan or individual retirement arrangement to the beneficiary or estate of the

[424] Present law does not provide relief from self-employment tax liability.

individual. Similarly, amounts payable only as death or survivor's benefits pursuant to deferred compensation preexisting arrangements that would have been paid if the death had occurred for another reason are not covered by the exemption. In addition, if the individual's employer makes adjustments to a plan or arrangement to accelerate the vesting of restricted property or the payment of nonqualified deferred compensation after the date of the particular attack, the exemption does not apply to income received as a result of that action.[425] Also, if the individual's beneficiary cashed in savings bonds of the decedent, the exemption does not apply. On the other hand, the exemption does apply, for example, to a final paycheck of the individual or dividends on stock held by the individual when paid to another person or the individual's estate after the date of death but before the end of the taxable year of the decedent (determined without regard to the death). The exemption also applies to payments of an individual's accrued vacation and accrued sick leave.

The tax relief does not apply to any individual identified by the Attorney General to have been a participant or conspirator in any terrorist attack to which the provision applies, or a representative of such individual.

Exclusion of death benefits

The Victims Act generally provides an exclusion from gross income for amounts received if such amounts are paid by an employer (whether in a single sum or otherwise[426]) by reason of the death of an employee who dies as a result of wounds or injury which were incurred as a result of the terrorist attacks that occurred on September 11, 2001, or April 19, 1995, or as a result of illness incurred due to an attack involving anthrax that occured on or after September 11, 2001, and before January 1, 2002. Subject to rules prescribed by the Secretary, the exclusion does not apply to amounts that would have been payable if the individual had died for a reason other than the attack. The exclusion does apply, however, to death benefits provided under a qualified plan that satisfy the incidental benefit rule.

For purposes of the exclusion, self-employed individuals are treated as employees. Thus, for example, payments by a partnership to the surviving spouse of a partner who died as a result of the September 11, 2001 attacks may be excludable under the provision.

The tax relief does not apply to any individual identified by the Attorney General to have been a participant or conspirator in any terrorist attack to which the provision applies, or a representative of such individual.

Estate tax relief

Present law provides a reduction in Federal estate tax for taxable estates of U.S. citizens or residents who are active members of the U.S. Armed Forces and who are killed in action

---

[425] Such amounts may, however, be excludable from gross income under the death benefit exclusion provided in section 102 of the Victims Act.

[426] Thus, for example, payments made over a period of years could qualify for the exclusion.

while serving in a combat zone (sec. 2201). This provision also applies to active service members who die as a result of wounds, disease, or injury suffered while serving in a combat zone by reason of a hazard to which the service member was subjected as an incident of such service.

In general, the effect of section 2201 is to replace the Federal estate tax that would otherwise be imposed with a Federal estate tax equal to 125 percent of the maximum State death tax credit determined under section 2011(b). Credits against the tax, including the unified credit of section 2010 and the State death tax credit of section 2011, then apply to reduce (or eliminate) the amount of the estate tax payable.

Generally, the reduction in Federal estate taxes under section 2201 is equal in amount to the "additional estate tax." The additional estate tax is the difference between the Federal estate tax imposed by section 2001 and 125 percent of the maximum State death tax credit determined under section 2011(b) as in effect prior to its repeal by the Economic Growth and Tax Relief Reconciliation Act of 2001.

The Victims Act generally treats individuals who die from wounds or injury incurred as a result of the terrorist attacks that occurred on September 11, 2001, or April 19, 1995, or as a result of illness incurred due to an attack involving anthrax that occurred on or after September 11, 2001, and before January 1, 2002, in the same manner as if they were active members of the U.S. Armed Forces killed in action while serving in a combat zone or dying as a result of wounds or injury suffered while serving in a combat zone for purposes of section 2201. Consequently, the estates of these individuals are eligible for the reduction in Federal estate tax provided by section 2201. The tax relief does not apply to any individual identified by the Attorney General to have been a participant or conspirator in any terrorist attack to which the provision applies, or a representative of such individual.

The Victims Act also changes the general operation of section 2201, as it applies to both the estates of service members who qualify for special estate tax treatment under present and prior law and to the estates of individuals who qualify for the special treatment only under the Act. Under the Victims Act, the Federal estate tax is determined in the same manner for all estates that are eligible for Federal estate tax reduction under section 2201. In addition, the executor of an estate that is eligible for special estate tax treatment under section 2201 may elect not to have section 2201 apply to the estate. Thus, in the event that an estate may receive more favorable treatment without the application of section 2201 in the year of death than it would under section 2201, the executor may elect not to apply the provisions of section 2201, and the estate tax owed (if any) would be determined pursuant to the generally applicable rules.

Under the Victims Act, section 2201 no longer reduces Federal estate tax by the amount of the additional estate tax. Instead, the Victims Act provides that the Federal estate tax liability of eligible estates is determined under section 2001 (or section 2101, in the case of decedents who were neither residents nor citizens of the United States), using a rate schedule that is equal to 125 percent of the pre-EGTRRA maximum State death tax credit amount. This rate schedule is used to compute the tax under section 2001(b) or section 2101(b) (i.e., both the tentative tax under section 2001(b)(1) and section 2101(b), and the hypothetical gift tax under section 2001(b)(2) are computed using this rate schedule). As a result of this provision, the estate tax is

unified with the gift tax for purposes of section 2201 so that a single graduated (but reduced) rate schedule applies to transfers made by the individual at death, based upon the cumulative taxable transfers made both during lifetime and at death.

In addition, while the Victims Act provides an alternative reduced rate table for purposes of determining the tax under section 2001(b) or section 2101(b), the amount of the unified credit nevertheless is determined as if section 2201 did not apply, based upon the unified credit as in effect on the date of death. For example, in the case of victims of the September 11, 2001, terrorist attack, the applicable unified credit amount under section 2010(c) would be determined by reference to the actual section 2001(c) rate table.

House Bill

No provision.

Senate Amendment

The Senate amendment extends the exclusion from income tax, the exclusion for death benefits, and the estate tax relief available under the Victims of Terrorism Tax Relief Act of 2001 to astronauts who lose their lives on a space mission (including the individuals who lost their lives in the space shuttle Columbia disaster).

Effective date.–The Senate amendment provision is generally effective for qualified individuals whose lives are lost on a space mission after December 31, 2002.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

XII. SUNSET PROVISION

A. Termination of Certain Provisions (sec. 1001 of the Senate amendment)

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.

House Bill

No provision.

Senate Amendment

To ensure compliance with the Budget Act, the Senate amendment 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 Senate amendment provision is effective on the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment.

The conference agreement does not modify the application of the Economic Growth Tax Reconciliation Relief Act of 2001 ("EGTRRA") sunset provision. The EGTRRA provision is contained in Title IX of Pub. L. No.107-16.

XIII. TAX COMPLEXITY ANALYSIS

The following tax complexity analysis is provided pursuant to section 4022(b) of the Internal Revenue Service Reform and Restructuring Act of 1998, which requires the staff of the Joint Committee on Taxation (in consultation with the Internal Revenue Service ("IRS") and the Treasury Department) to provide a complexity analysis of tax legislation reported by the House Committee on Ways and Means, the Senate Committee on Finance, or a Conference Report containing tax provisions. The complexity analysis is required to report on the complexity and administrative issues raised by provisions that directly or indirectly amend the Internal Revenue Code and that have widespread applicability to individuals or small businesses. For each such provision identified by the staff of the Joint Committee on Taxation, a summary description of the provision is provided along with an estimate of the number and type of affected taxpayers, and a discussion regarding the relevant complexity and administrative issues.

Following the analysis of the staff of the Joint Committee on Taxation are the comments of the IRS and the Treasury Department regarding each of the provisions included in the complexity analysis, including a discussion of the likely effect on IRS forms and any expected impact on the IRS.

1. Increase the child tax credit (sec. 101 of the conference agreement)

Summary description of provision

The amount of the child credit is increased to $1,000 for 2003 and 2004, reverting to present law phase-in thereafter. For 2003, the increased amount of the child credit will be paid in advance beginning in July 2003 on the basis of information on each taxpayer's 2002 return filed in 2003. Advance payments will be made in a manner similar to the advance payment checks issued by the Treasury in 2001 to reflect the creation of the 10-percent regular income tax rate bracket.

Number of affected taxpayers

It is estimated that the provisions will affect approximately 27 million individual tax returns.

Discussion

Individuals should not have to keep additional records due to this provision, nor will additional regulatory guidance be necessary to implement this provision.

The IRS will need to add to the individual income tax forms package a new worksheet so that taxpayers can reconcile the amount of the check they receive from the Department of the Treasury with the credit they are allowed as an acceleration of the child tax credit for 2003. This worksheet should be relatively simple and many taxpayers will not need to fill it out completely because they will have received the full amount by check.

2. Expansion of the 15-percent rate bracket (sec. 102 of the conference agreement)

Summary description of provision

The bill accelerates the increase of the size of the 15-percent regular income tax rate bracket for married individuals filing joint returns to twice the width of the 15-percent regular income tax rate bracket for unmarried individual returns effective for 2003 and 2004, reverting to present-law phase-in for 2005 and thereafter.

Number of affected taxpayers

It is estimated that the provision will affect approximately 19 million individual tax returns.

Discussion

It is not anticipated that individuals will need to keep additional records due to this provision. The increased size of the 15-percent regular income tax rate bracket for married individuals filing joint returns should not result in an increase in disputes with the IRS, nor will regulatory guidance be necessary to implement this provision.

3. Standard deduction tax relief (sec. 103 of the conference agreement)

Summary description of provision

The conference agreement accelerates the increase in the basic standard deduction amount for joint returns to twice the basic standard deduction amount for unmarried individual returns effective for 2003 and 2004, reverting to present-law phase-in for 2005 and thereafter.

Number of affected taxpayers

It is estimated that the provision will affect approximately 22 million individual returns.

Discussion

It is not anticipated that individuals will need to keep additional records due to this provision. The higher basic standard deduction should not result in an increase in disputes with the IRS, nor will regulatory guidance be necessary to implement this provision. In addition, the provision should not increase individuals' tax preparation costs.

Some taxpayers who currently itemize deductions may respond to the provision by claiming the increased standard deduction in lieu of itemizing. According to estimates by the staff of the Joint Committee on Taxation, approximately three million individual tax returns will realize greater tax savings from the increased standard deduction than from itemizing their deductions. In addition to the tax savings, such taxpayers will no longer have to file Schedule A to Form 1040 and a significant number of which will no longer need to engage in the record keeping inherent in itemizing below-the-line deductions. Moreover, by claiming the standard deduction, such taxpayers may qualify to use simpler versions of the Form 1040 (i.e., Form

1040EZ or Form 1040A) that are not available to individuals who itemize their deductions. These forms simplify the return preparation process by eliminating from the Form 1040 those items that do not apply to particular taxpayers.

This reduction in complexity and record keeping also may result in a decline in the number of individuals using a tax preparation service or a decline in the cost of using such a service. Furthermore, if the provision results in a taxpayer qualifying to use one of the simpler versions of the Form 1040, the taxpayer may be eligible to file a paperless Federal tax return by telephone. The provision also should reduce the number of disputes between taxpayers and the IRS regarding substantiation of itemized deductions.

4. Reduction in income tax rates for individuals (secs. 104 and 105 of the conference agreement)

Summary description of provision

The conference agreement accelerates the scheduled increase in the taxable income levels for the 10-percent rate bracket from 2008 to 2003 and 2004, reverting to the present-law phasein for 2005 and thereafter. Specifically, the conference agreement increases the taxable income level for the 10-percent regular income tax rate brackets for unmarried individuals from $6,000 to $7,000 and for married individuals filing jointly from $12,000 to $14,000. For taxable years beginning after 2004, the amounts will revert to the levels provided in present-law (e.g., $7,000 for unmarried individuals and $12,000 for married couples filing jointly for 2005).

Also, the conference agreement 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, the regular income tax rates in excess of 15 percent under the conference agreement are 25 percent, 28 percent, 33 percent, and 35 percent for 2003 and thereafter.

Number of affected taxpayers

It is estimated that the provision will affect approximately 76 million individual tax returns.

Discussion

It is not anticipated that individuals will need to keep additional records due to this provision. It should not result in an increase in disputes with the IRS, nor will regulatory guidance be necessary to implement this provision. In addition, the provision should not increase the tax preparation costs for most individuals. Reductions in the regular income tax as a result of these rate reductions as well as the expansion of the child credit, standard deduction, and 10-percent bracket, will cause some taxpayers to become subject to the alternative minimum tax.

The Secretary of the Treasury is expected to make appropriate revisions to the wage withholding tables to reflect the proposed rate reduction for calendar year 2003 as expeditiously as possible. To implement the effects of the additional amount of child tax credit for 2003, employers would be required to use a new (second) set of withholding rate tables to determine

the correct withholding amounts for each employee. Switching to the new withholding rate tables during the year can be expected to result in a one-time additional burden for employers.

5. Bonus depreciation (sec. 201 of the conference agreement)

Summary description of provision

The conference agreement provides an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified property. Qualified property is defined in the same manner as for purposes of the 30-percent additional first-year depreciation deduction provided by the Job Creation and Workers Assistance Act of 2002, except that the applicable time period for acquisition (or self construction) of the property is modified. In general, in order to qualify the property must be acquired after May 5, 2003, and before January 1, 2005, and no binding written contract for the acquisition is in effect before May 6, 2003. Property eligible for the 50-percent additional first year depreciation deduction is not eligible for the 30-percent additional first year depreciation deduction.

Number of affected taxpayers

It is estimated that more than 10 percent of small businesses will be affected by the provision.

Discussion

It is not anticipated that small businesses will have to keep additional records due to this provision, nor will additional regulatory guidance be necessary to implement this provision. It is not anticipated that the provision will result in an increase in disputes between small businesses and the IRS. However, small businesses will have to perform additional analysis to determine whether property qualifies for the provision. In addition, for qualified property, small businesses will be required to perform additional calculations to determine the proper amount of allowable depreciation. Complexity may also be increased because the provision is temporary. For example, different tax treatment will apply for identical equipment based on the acquisition and placed in service date. Further, the Secretary of the Treasury is expected to have to make appropriate revisions to the applicable depreciation tax forms.

6. Capital gain rate reduction (sec. 301 of the conference agreement)

Summary description of provision

The conference agreement reduces the 10- and 20-percent rates on the adjusted net capital gain to five and 15 percent, respectively. These lower rates apply to both the regular tax and the alternative minimum tax. The lower rates apply to assets held more than one year. The five percent rate becomes zero percent for taxable years beginning after 2007. The conference agreement applies to taxable years ending on or after May 6, 2003, and beginning before January 1, 2009.

For taxable years that include May 6, 2003, the lower rates apply to amounts properly taken into account for the portion of the year on or after that date. This generally has the effect

of applying the lower rates to capital assets sold or exchanged (and installment payments received) on or after May 6, 2003. In the case of gain and loss taken into account by a pass-through entity, the date taken into account by the entity is the appropriate date for applying this rule.

Number of affected taxpayers

It is estimated that the provisions will affect over 15 million individual tax returns.

Discussion

The elimination of the five-year holding period means that taxpayers with gains on assets held for more than 5 years will no longer need to separately compute tax for such gain on schedule D of Form 1040. Additionally, the form will not need to be expanded beginning in 2006 to separate out gain of capital assets held more than five years that were purchased after 2000. This may reduce tax preparation costs. Mutual fund reporting on the Form 1099 will be made easier by the elimination of the five-year holding period.

For 2003, multiple rates will be in effect depending on whether gain was realized before or after May 6, 2003. This will make the schedule D more complicated for tax year 2003, and may increase tax preparation costs.

7. Dividend tax relief (sec. 302 of the conference agreement)

Summary description of provision

Under the conference agreement, qualified dividends received by an individual shareholder from domestic and qualified foreign corporations are generally taxed at the rates that apply to net capital gain. This treatment applies for purposes of both the regular tax and the alternative minimum tax. Thus, under the conference agreement, dividends will be taxed at rates of five and 15 percent, the same rates applicable to net capital gain.

If a shareholder does not hold a share of stock for more than 60 days during the 120-day period beginning 60 days before the ex-dividend date, dividends received on the stock are not eligible for the reduced rates. Also, the reduced rates are 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.

Number of affected taxpayers

It is estimated that the provisions will affect over 20 million individual tax returns.

Discussion

Individuals computing their tax will need to add qualified dividends to net capital gain in computing their income tax using the tax computation portion of Schedule D of Form 1040 (or other tax computation forms or schedules as the Internal Revenue Service may prescribe).

Additional individuals will need to use the tax computation schedule, which may increase tax preparation costs.

New Form 1099s will need to differentiate qualified from nonqualified dividends, and additional burdens will be imposed on payors to comply with the new Form 1099 reporting. Additional record keeping will be necessary with respect to compliance with the 60-day holding period rules. It is likely that there will be increased taxpayer errors with respect to the proper reporting of dividends as a result.

8. [insert IRS letter]

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER

Ms. Mary Schmitt
Acting Chief of Staff
Joint Committee on Taxation
Washington, D.C. 20515

Dear Ms. Schmitt:

Enclosed are the combined comments of the Internal Revenue Service and the Treasury Department on the seven provisions from the House and Senate markup of H.R. 2, the "Jobs and Growth Tax Relief Reconciliation Act of 2003," that your staff identified for complexity analysis in their May 22, 2003 telephone calls to the IRS Legislative Affairs Division.

Our comments are based on the description of those provisions in the enclosed analysis. Due to the short turnaround time, our comments are provisional and subject to change upon a more complete and in-depth analysis of the provisions.

Sincerely,

Kevin M. Brown/For Mark Everson

Mark W. Everson

Enclosure

COMPLEXITY ANALYSIS OF THE
JOBS AND GROWTH RECONCILIATION TAX ACT OF 2003

Acceleration of the Increase In the Child Tax Credit

Provision:

The amount of the child credit is increased to $1,000 for 2003 and 2004. For 2003, the increased amount ($400) will be paid in advance beginning in July 2003 on the basis of information on each taxpayer's 2002 return. Advance payments are to 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. After 2005 the child credit will revert to the levels provided in present law (e.g., $700 for 2005).

IRS and Treasury Comments:

- No new forms would be required as a result of the child tax credit provisions mentioned above.
- The increased amount of the child tax credit and the increased refundable portion would be incorporated in the instructions for Forms 1040, 1040A, 1040NR, 1040-PR, and 1040-SS for 2003 and 2004.
- The applicable amount of the child tax credit for 2005 and later years would be incorporated in the instructions for Form 1040, 1040A, 1040NR, 1040-PR, and on Form 1040-ES for 2005 and later years.
- Subsequent to enactment, the IRS would have to advise taxpayers who make estimated tax payments for 2003 how they can adjust their estimated tax payments for 2003 to reflect the increased child tax credit, the increased refundable portion, and the required reduction for those who receive advance payments.
- Supplemental programming changes would be required for processing 2003 returns to reflect the increased child tax credit, the increased refundable portion, and the required reduction for those who receive advance payments.
- Programming changes would be required for 2004 and later years to reflect the reversion of the applicable child tax credit amount to the amounts currently scheduled for the years. Currently, the IRS computation programs are updated annually to incorporate mandated inflation adjustments. Programming changes necessitated by the provision would be included during that process.

Advance Payment Feature

- An estimated 26 million checks will be mailed beginning in July 2003.

- It will take three weeks to mail checks to those taxpayers whose 2002 tax returns have already been filed and processed. Checks for taxpayers whose returns are filed and processed later in the year will be mailed weekly, through the end of December 2003.

- Some taxpayers may be entitled to more than their advance payment checks due to changes in financial or family status between 2002 and 2003. For example, IRS will not know if a taxpayer gives birth to a child or adopts a child in 2003 until the taxpayer files the 2003 tax return. If they are entitled to a larger increase in the child tax credit than they received in their advance payment checks, they will get the additional amounts on their 2003 tax returns.

- Notices will be sent to taxpayers informing them of the amount of their advance payment, the number of children used to compute the amount, if the amount was limited due to the phase-out range, tax liability, or earned income. The notices will also advise taxpayers that this amount will have to be taken into account in determining the amount of their child tax credit on the 2003 tax return.

- Two lines will be added to the Child Tax Credit Worksheet for 2003. Based on experience with the 2001 rate reduction credit and advance payment, it is anticipated that a number of taxpayers will make errors in this computation on their 2003 tax returns.

- The advance payment will require programming changes to compute the amount and resources to answer taxpayer questions, print and mail notices, and correct errors made on 2003 returns as a result of the advance payment

Acceleration of the Standard Deduction Tax Relief

Provision:

The basic standard deduction amount for joint returns is increased to twice the basic standard deduction amount for unmarried individual returns, effective for 2003 and 2004. After 2004, the applicable percentages will revert to present-law levels (e.g., 174 percent of the basic standard deduction for unmarried individuals for 2005).

IRS and Treasury Comments:

- The increased basic standard deduction for married taxpayers would be incorporated in the instructions for Forms 1040, 1040A, 1040EZ, and on Forms 1040, 1040A, and 1040EZ for 2003, 2004, and 2005. No new forms would be required.

- The amount of the basic standard deduction for married taxpayers after 2004 (based on reversion to the currently scheduled levels) would be incorporated in the instructions for Forms 1040, 1040A, 1040EZ, and on Forms W-4, 1040, 1040A, 1040EZ, and 1040-ES for 2005 and later years.

- Subsequent to enactment, the IRS would have to advise taxpayers how they can adjust their estimated tax payment or federal income tax withholding for 2003 to reflect the increased basic standard deduction.

- Supplemental programming changes would be required to reflect the increased basic standard deduction for 2003.

- Programming changes would be required in 2005 and later to reflect the reversion of the standard deduction amounts to the currently scheduled amounts for those years. Currently, the IRS computation programs are updated annually to incorporate mandated inflation adjustment. Programming changes necessitated by the provision would be included during that process.

- The larger basic standard deduction would reduce the number of taxpayers who itemize their deductions in 2003 and 2004. It would also reduce the number of taxpayers who are required to file income tax returns in those years.

Acceleration of the Expansion of the 15-Percent Rate Bracket

Provision:

The width of the 15-percent regular income tax rate bracket for joint returns is increased to twice the width of the 15-percent regular income tax rate bracket for unmarried individual returns, effective for 2003 and 2004. After 2004, the end point of the 15-percent rate bracket for married couples filing joint returns (as a percentage of the end point of the 15-percent rate bracket for unmarried individuals) will revert to present-law levels (i.e., 180 percent of the end point of the 15-percent rate bracket for unmarried individuals for 2005).

IRS and Treasury Comments:

- The expanded 15-percent rate bracket for married taxpayers would be incorporated in the tax tables and the tax rate schedules shown in the instructions for Forms 1040, 1040A, 1040EZ, and 1040NR for 2003 and 2004. No new forms would be required.

- The applicable width of the 15-percent rate bracket for married taxpayers after 2004 (based on reversion to the currently scheduled levels) would be incorporated in the tax tables and tax rate schedules shown in the instructions for

Forms 1040, 1040A, 1040EZ, and 1040NR and on Form 1040-ES for 2005 and later years.

- The expanded 15-percent rate bracket would also be incorporated in the tax rate schedules shown on Form 1040-ES for 2004. Subsequent to enactment, the IRS would have to advise taxpayers who make estimated tax payments for 2003 how they can adjust their estimated tax payments for 2003 to reflect the expanded 15-percent rate bracket.

- Supplemental programming changes would be required to reflect the expanded 15-percent rate bracket for 2003.

- Programming changes would be required to reflect the reversion to present law levels for determining the width of the 15-percent rate bracket for 2005 and later years. Currently, the IRS computation programs are updated annually to incorporate mandated inflation adjustments. Programming changes necessitated by the provision would be included during that process.

- New withholding rate tables and schedules to update the current Circular E for use by employers during the remainder of calendar year 2003 would be required.

Acceleration of the Reduction of Regular Individual Income Tax Rates

Provision:

The conference agreement accelerates the scheduled increase in the taxable income levels for the 10-percent rate bracket from 2008 to 2003 and 2004, reverting to the present-law phase-in for 2005 and thereafter. Specifically, the conference agreement increases the taxable income level for the 10-percent regular income tax rate brackets for unmarried individuals from $6,000 to $7,000 and for married individuals filing jointly from $12,000 to $14,000. For taxable years beginning after 2004, the amounts will revert to the levels provided in present-law (i.e., $6,000 for unmarried individuals and $12,000 for married couples filing jointly for 2005).

Also, the conference agreement 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, the regular income tax rates in excess of 15 percent under the conference agreement are 25 percent, 28 percent, 33 percent, and 35 percent for 2003 and thereafter.

IRS and Treasury Comments:

- No new forms would be required as a result of the above-mentioned provisions.

- The increased taxable income levels for the 10-percent rate bracket would be incorporated in the tax tables and tax rate schedules shown in the instructions for Forms 1040, 1040A, 1040EZ, 1040NR, and 1040NR-EZ for 2003 and 2004.

- The reduced tax rates would be incorporated in the tax tables and tax rate schedules shown in the instructions for Forms 1040, 1040A, 1040EZ, 1040NR, 1040NR-EZ, and 1041 for 2003 and 2004.

- Changes to the 10-percent rate bracket for tax years beginning after 2004 resulting from the reversion to the present-law phase-in schedule would be incorporated in the tax tables and tax rate schedules shown in the instructions for Forms 1040, 1040A, 1040EZ, 1040NR, and 1040NR-EZ and on Form 1040-ES for 2005 and later years. Currently, the IRS computation programs are updated annually to incorporate mandated inflation adjustments. Programming changes necessitated by the provision would be included during that process.

- The increased taxable income levels for the 10-percent rate bracket and the reduced tax rates would also be incorporated in the tax rate schedules shown on Form 1040-ES for 2004. Subsequent to enactment, the IRS would have to advise taxpayers who make estimated tax payments for 2003 how they can adjust their estimated tax payments for 2003 to reflect the increased taxable income levels for the 10-percent rate bracket and the reduced rates.

Special Depreciation Allowance for Certain Property

Provision:

The bill provides an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified property. Qualified property is defined in the same manner as for purposes of the 30-percent additional first-year depreciation deduction provided by the Job Creation and Workers Assistance Act of 2002, except that the applicable time period for acquisition (or self construction) of the property is modified. In general, in order to qualify, the property must be acquired after May 5, 2003, and before January 1, 2006, and no binding written contract for the acquisition can be in effect before May 6, 2003. Property eligible for the 50-percent additional first-year depreciation deduction is not eligible for the 30-percent additional first-year depreciation deduction.

IRS and Treasury Comments:

- The increase and extension of additional first-year depreciation would have no significant impact on Form 4562 or any other tax forms. The instructions for Form 4562 and other instructions and publications would be expanded to explain and implement the new rules.
- No programming changes would be required by this provision.

Reduced Individual Capital Gains Rates

Provision:

The 10- and 20-percent rates on the adjusted net capital gain are reduced to 5 and 15 percent, respectively, effective in taxable years ending on or after May 6, 2003, and beginning before January 1, 2009.

For taxable years that include May 6, 2003, the lower rates apply to amounts properly taken into account for the portion of the year on or after that date. This generally has the effect of applying the lower rates to capital assets sold or exchanged (and installment payments received) on or after May 6, 2003.

IRS and Treasury Comments:

- The mid-year effective date of May 6, 2003, creates complexity and burden for taxpayers, and will likely result in a large number of errors (as occurred in 1997 when similar mid-year changes were made to the capital gains tax rate). A January 1, 2003, effective date would greatly simplify matters for 2003 (instead of adding 8 lines to several products for 2003 as described below, 4 lines would be removed).

- To figure the amount of gain taxed at 5% and 15% for 2003, 8 lines would be added to: Schedule D (Form 1040); the Schedule D Tax Worksheet; Form 6251 (alternative minimum tax); and Form 8801 (credit for prior year minimum tax).

- Column (g) of Schedule D would be revised to request information for amounts applicable to the portion of the tax year after May 5, 2003. Additional instructions and a 6-line worksheet would be added to figure 28% rate gain or loss, as that amount is currently figured in column (g).
- Rules would have to be developed and applied for 2003 to account for the limit on net section 1231 losses, capital loss carryforwards, carryforwards not allowed due to passive activity rules or at-risk rules, etc.
- The amount of net capital gain for the portion of the tax year after May 5, 2003, would have to be transcribed from the tax return and programming changes would be required to figure the amount of gain taxed at 5% and 15%.
- For 2003, Form 1099-DIV filers would be required to figure and report to recipients the amount of gain after May 5, 2003.
- Taxpayers whose only capital gains are capital gain distributions would not be able to use the shorter Capital Gain Tax Worksheet in the instructions for Form 1040 and Form 1040A, but instead would be required to file Form 1040 and attach Schedule D, to report the amount of their capital gain distributions properly taken into account after May 5, 2003, and figure their tax using the 5%, 10%, 15%, and

20% capital gains tax rates. This provision would therefore increase the number of taxpayers filing Schedule D by up to 6 million.

- For 2004, the 8 lines added for 2003 and 4 current lines (used to figure the 8% rate) would be removed from: Schedule D; the Schedule D Tax Worksheet; Form 6251; and Form 8801.
- The 8-line Qualified 5-Year Gain Worksheet in the Instructions for Schedule D would not be necessary after 2003.
- For 2006, when the 18% capital gains tax rate becomes effective for individuals, this provision would also save us from having to add 4 lines to Schedule D, the Schedule D Tax Worksheet, Form 6251, Form 8801, and the Qualified 5-Year Gain Worksheet.
- Form 1099-DIV filers would not be required to report qualified 5-year gain after 2003, and would not be required in 2005 to begin reporting qualified 5-year gain eligible for the 18% rate.
- For tax years beginning after 2008, the 5% and 15% rates would cease to apply, the 8% rate on qualified 5-year gain would again apply, and the 18% rate on qualified 5-year gain on property acquired after 2000 would begin to apply. At least 8 lines would have to be added to the 2009 Schedule D (Form 1040) and 2009 Schedule D Tax Worksheet, 2009 Form 6251, and Form 8801. A worksheet of at least 8 lines would be required to figure the 8% and 18% qualified 5-year gain amounts. Several million taxpayers, filing Form 1040 or 1040A, whose only capital gains are capital gain distributions and dividends would no longer be eligible to figure their tax using a short Capital Gain Tax Worksheet, but instead would be required to file Form 1040 and Schedule D. Form 1099-DIV filers would again have to track and report 8% qualified 5-year gain, and would have to begin reporting 18% qualified 5 year gain.

Dividend Income of Individuals

Provision:

Dividends received by an individual shareholder from domestic corporations are taxed at the rates for net capital gain (5 or 15 percent per the above reduction in the capital gains rate), effective for taxable years beginning after 2002 and before 2013.

If a shareholder does not hold a share of stock for more than 60 days during the 90-day period beginning 60 days before the ex-dividend date, dividends received on the stock are not eligible for the capital gain rates. Also, the capital gain rates are 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. Other rules apply.

IRS and Treasury Comments:

- No new forms would be required as a result of the above-mentioned provision.
- A box to report qualified dividends would be added to Form 1099-DIV for 2004 through 2012.
- Subsequent to enactment, the IRS would have to issue a revised Form 1099-DIV for 2003 and advise taxpayers who make estimated tax payments for 2003 how they can adjust their estimated tax payments to reflect the new tax rates applicable to qualified dividends.
- Two lines would be added to Part IV of Schedule D (and the Schedule D Tax Worksheet) for 2003 through 2012 to increase net capital gain by the amount of qualified dividends.
- The new tax rates applicable to qualified dividends would be reflected in the instructions for Forms 1040 and 1040A for 2003 through 2012.
- Taxpayers who have qualified dividends would be required to report them on Schedule D and complete up to 19 lines (23 lines for 2003) in Part IV of Schedule D to figure their tax using the 15% and 5% capital gains tax rates, even if they did not otherwise have a net capital gain. For example, taxpayers whose only income was wages, interest, and dividends reported on Form 1040A would now be required to file Form 1040 and attach Schedule D to report the amount of qualified dividends and figure their tax.
- Supplemental programming changes would be required to reflect the new tax rates applicable to qualified dividends for 2003.
- Programming changes would be required to reflect the tax rates applicable to qualified dividends after 2012. Currently, the IRS tax computation programs are updated annually to incorporate mandated inflation adjustments. Programming changes necessitated by the provision would be included during that process.
- Technical guidance (regulations, revenue rulings, etc.) will probably be needed to implement the anti-abuse rules.
- For tax years beginning after 2008, the additional lines added for 2003-2007--one line for Form 1040 and two lines in each place tax is figured using capital gains tax rates (Schedule D, Schedule D Tax Worksheet, and Capital Gain Tax Worksheets)--would be removed.

Effect of All Bill Provisions on AMT

Despite specific changes which tend to increase the number of AMT taxpayers, the bill's increases in the AMT exemption amounts for 2003-2004 would significantly reduce the number of AMT taxpayers in those years relative to current law.

ESTIMATED BUDGET EFFECTS OF THE CONFERENCE AGREEMENT FOR H.R. 2
THE "JOBS AND GROWTH TAX RELIEF RECONCILIATION ACT OF 2003"

Fiscal Years 2003 - 2013

[Millions of Dollars]

Provision	Effective	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2003-08	2003-13
Acceleration of Certain Previously Enacted Tax Reductions														
1. Expand the child credit to $1,000 for 2003 through 2004; revert to present-law phase in for 2005 [1]	tyba 12/31/02	-13,712	-5,820	-12,956	---	---	---	---	---	---	---	---	-32,488	-32,488
2. Accelerate the expansion of the 15% individual income tax rate bracket and the increase in the standard deduction for married taxpayers filing joint returns; revert to present-law phase in for 2005	tyba 12/31/02	-4,936	-24,904	-5,234	---	---	---	---	---	---	---	---	-35,074	-35,074
3. Accelerate the expansion of the 10% bracket; revert to present-law phase in for 2005	tyba 12/31/02	-1,549	-8,445	-1,912	---	---	---	---	---	---	---	---	-11,906	-11,906
4. Accelerate the 2006 rate schedule	tyba 12/31/02	-9,531	-38,809	-19,930	-5,915	---	---	---	---	---	---	---	-74,185	-74,185
5. Increase individual AMT exemption amount by $4,500 single and $9,000 joint for 2003 and 2004	tyba 12/31/02	-1,176	-10,346	-6,260	---	---	---	---	---	---	---	---	-17,782	-17,782
Total of Acceleration of Certain Previously Enacted Tax Reductions		**-30,904**	**-88,324**	**-46,292**	**-5,915**	**---**	**---**	**---**	**---**	**---**	**---**	**---**	**-171,435**	**-171,435**
Growth Incentives for Business														
1. Increase bonus depreciation to 50% and extend through 12/31/04	ppisa 5/5/03 [2]	-9,918	-33,298	-11,684	9,414	9,300	8,112	6,648	4,987	3,586	2,212	1,447	-28,074	-9,194
2. Increase section 179 expensing - increase the amount that can be expensed from $25,000 to $100,000 and increase the phaseout threshold amount from $200,000 to $400,000; include software in section 179 property; and index both the deduction limit and the phaseout threshold after 2003 (sunset after 2005)	tyba 12/31/02	-1,647	-2,681	-3,690	-1,027	2,724	1,842	1,290	937	647	410	243	-4,479	-952
Total of Growth Incentives for Business		**-11,565**	**-35,979**	**-15,374**	**8,387**	**12,024**	**9,954**	**7,938**	**5,924**	**4,233**	**2,622**	**1,690**	**-32,553**	**-10,146**
Reductions in Taxes on Dividends and Capital Gains														
1. Tax capital gains with a 15%/5% rate structure for 2003 though 2007, and 15%/0% in 2008 (sunset 12/31/08)	so/a 5/6/03	-62	-928	-1,335	-3,042	-4,454	-3,544	509	-9,532	---	---	---	-13,365	-22,386
2. Tax dividends with a 15%/5% rate structure for 2003 though 2007, and 15%/0% in 2008 (sunset 12/31/08) [3]	dri tyba 12/31/02	-4,250	-17,506	-19,215	-20,081	-21,263	-23,203	-19,689	-493	---	---	---	-105,518	-125,700
Total of Reductions in Taxes on Dividends and Capital Gains		**-4,312**	**-18,434**	**-20,550**	**-23,123**	**-25,717**	**-26,747**	**-19,180**	**-10,025**	**---**	**---**	**---**	**-118,883**	**-148,086**

Provision	Effective	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2003-08	2003-13
Temporary State Fiscal Relief Fund (outlay effects) [4] ……	**DOE**	**-7,730**	**-12,270**	**---**	**---**	**---**	**---**	**---**	**---**	**---**	**---**	**---**	**-20,000**	**-20,000**
Special Estimated Tax Rules for Certain Corporate Estimated Tax Payments (25% of estimated payments otherwise due on September 15 are payable on October 1, 2003) ……	**DOE**	**-6,325**	**6,325**	**---**	**---**	**---**	**---**	**---**	**---**	**---**	**---**	**---**	**---**	**---**
Total, Net of Outlays ……		**-49,489**	**-135,370**	**-77,567**	**-20,575**	**-13,648**	**-16,749**	**-11,190**	**-4,101**	**4,233**	**2,622**	**1,690**	**-313,398**	**-320,142**
Total Outlay Effects ……		**-11,347**	**-13,312**	**-4,649**	**-76**	**-45**	**-44**	**-52**	**---**	**---**	**---**	**---**	**-29,473**	**-29,525**
TOTAL [5] ……		**-60,836**	**-148,682**	**-82,216**	**-20,651**	**-13,693**	**-16,793**	**-11,242**	**-4,101**	**4,233**	**2,622**	**1,690**	**-342,871**	**-349,667**

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding.

Legend for "Effective" column:

DOE = date of enactment
dri = dividends received in
ppisa = property placed in service after
so/a = sales on or after
tyba = taxable years beginning after

[1] Advance payment of 2003 child credit paid by rebate with safe harbor.
[2] Does not apply to any property with binding contract in place before May 6, 2003.
[3] Any dividend described in Internal Revenue Code section 404(k) would be taxed at ordinary rates. RIC and REIT shareholders receive tax relief to the extent that dividends paid by the RIC or REIT are qualified dividends received by the RIC or REIT. Taxed REIT income would receive the preferential tax rates when distributed as dividends. The provision excludes qualified dividends from investment income for the purpose of Internal Revenue Code Section 163(d). Certain anti-abuse rules, including the imposition of a 60-day holding period, apply. Certain foreign dividends would qualify for the preferential rates.
[4] Estimate provided by the Congressional Budget Office.
[5] Returns with AMT liability (millions):

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Present law ……	2.2	3.7	9.7	14.9	19.2	23.8	26.8	30.0	14.2	17.3	20.3
Change due to proposal ……	0.2	-0.8	1.6	---	---	---	---	---	---	---	---

H.R. 2

Managers on the part of the HOUSE	*Managers on the part of the* SENATE
William M. Thomas Mr. Thomas	
Tom DeLay Mr. DeLay	
[redacted]	

H.R. 2—Continued

Managers on the part of the HOUSE	*Managers on the part of the* SENATE
	Mr. Grassley Chuck Grassley
	Mr. Hatch Orrin Hatch
	Mr. Nickles D Nickles
	Mr. Lott Trent Lott
	[redacted]
	[redacted]
	[redacted]