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108TH CONGRESS } HOUSE OF REPRESENTATIVES { REPORT
1st Session } { 108–393

AMERICAN JOBS CREATION ACT OF 2003

NOVEMBER 21, 2003.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. THOMAS, from the Committee on Ways and Means,
submitted the following

R E P O R T

together with

DISSENTING VIEWS

[To accompany H.R. 2896]

[Including cost estimate of the Congressional Budget Office]

The Committee on Ways and Means, to whom was referred the bill (H.R. 2896) to amend the Internal Revenue Code of 1986 to remove impediments in such Code and make our manufacturing, service, and high-technology businesses and workers more competitive and productive both at home and abroad, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

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90–621

The amendment is as follows:

Strike all after the enacting clause and insert the following:

SECTION 1. SHORT TITLE; ETC.

(a) SHORT TITLE.—This Act may be cited as the "American Jobs Creation Act of 2003".

(b) AMENDMENT OF 1986 CODE.—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1986.

(c) TABLE OF CONTENTS.—

TITLE I—CORPORATE REFORM AND GROWTH INCENTIVES

Subtitle A—Reduction in Corporate Income Tax Rates

SEC. 1001. REDUCED CORPORATE INCOME TAX RATE FOR DOMESTIC PRODUCTION ACTIVITIES INCOME.

(a) LIMITATION ON TAX ON QUALIFIED PRODUCTION ACTIVITIES INCOME.—Section 11 is amended by redesignating subsections (c) and (d) as subsections (d) and (e), respectively, and by inserting after subsection (b) the following new subsection:

"(c) LIMITATION ON TAX ON QUALIFIED PRODUCTION ACTIVITIES INCOME.—

"(1) IN GENERAL.—If a corporation has qualified production activities income for any taxable year, the tax imposed by this section shall not exceed the sum of—

"(A) a tax computed at the rates and in the manner as if this subsection had not been enacted on the taxable income reduced by the amount of qualified production activities income, plus

"(B) a tax equal to 32 percent (34 percent in the case of taxable years beginning before January 1, 2007) of the qualified production activities income (or, if less, taxable income).

"(2) QUALIFIED PRODUCTION ACTIVITIES INCOME.—

"(A) IN GENERAL.—The term 'qualified production activities income' for any taxable year means an amount equal to the excess (if any) of—

"(i) the taxpayer's domestic production gross receipts for such taxable year, over

"(ii) the sum of—

"(I) the cost of goods sold that are allocable to such receipts,

"(II) other deductions, expenses, or losses directly allocable to such receipts, and

"(III) a ratable portion of other deductions, expenses, and losses that are not directly allocable to such receipts or another class of income.

"(B) ALLOCATION METHOD.—The Secretary shall prescribe rules for the proper allocation of items of income, deduction, expense, and loss for purposes of determining income attributable to domestic production activities.

"(3) DOMESTIC PRODUCTION GROSS RECEIPTS.—For purposes of this subsection, the term 'domestic production gross receipts' means the gross receipts of the taxpayer which are derived from—

"(A) any lease, rental, license, sale, exchange, or other disposition of—

"(i) qualifying production property which was manufactured, produced, grown, or extracted in whole or in significant part by the taxpayer within the United States, or

"(ii) any qualified film produced by the taxpayer, or

"(B) construction, engineering, or architectural services performed in the United States for construction projects in the United States.

"(4) QUALIFYING PRODUCTION PROPERTY.—For purposes of this subsection, the term 'qualifying production property' means—

"(A) tangible personal property,

"(B) any computer software, and

"(C) any property described in section 168(f)(4).

"(5) QUALIFIED FILM.—For purposes of this subsection—

"(A) IN GENERAL.—The term 'qualified film' means any property described in section 168(f)(3) if not less than 50 percent of the total compensation relating to the production of such property is compensation for services performed in the United States by actors, production personnel, directors, and producers.

"(B) EXCEPTION.—Such term does not include property with respect to which records are required to be maintained under section 2257 of title 18, United States Code.

"(6) RELATED PERSONS.—For purposes of this subsection—

"(A) IN GENERAL.— The term 'domestic production gross receipts' shall not include any gross receipts of the taxpayer derived from property leased, licensed, or rented by the taxpayer for use by any related person.

"(B) RELATED PERSON.—For purposes of subparagraph (A), a person shall be treated as related to another person if such persons are treated as a single employer under subsection (a) or (b) of section 52 or subsection (m) or (o) of section 414, except that determinations under subsections (a) and (b) of section 52 shall be made without regard to section 1563(b).".

(b) SPECIAL RULE RELATING TO ELECTION TO TREAT CUTTING OF TIMBER AS A SALE OR EXCHANGE.—In the case of a corporation, any election under section 631(a) of the Internal Revenue Code of 1986 made for a taxable year ending on or before the date of the enactment of this Act may be revoked by the taxpayer for any taxable year ending after such date. For purposes of determining whether such taxpayer may make a further election under such section, such election (and any revocation under this section) shall not be taken into account.

(c) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years beginning after December 31, 2003.

SEC. 1002. REDUCED CORPORATE INCOME TAX RATE FOR SMALL CORPORATIONS.

(a) IN GENERAL.—Subsection (b) of section 11 (relating to tax imposed on corporations) is amended by redesignating paragraph (2) as paragraph (6) and by striking paragraph (1) and inserting the following new paragraphs:

"(1) FOR TAXABLE YEARS BEGINNING AFTER 2011.—In the case of taxable years beginning after 2011, the amount of the tax imposed by subsection (a) shall be determined in accordance with the following table:

"If taxable income is:	The tax is:
Not over $50,000	15% of taxable income.
Over $50,000 but not over $75,000	$7,500, plus 25% of the excess over $50,000.
Over $75,000 but not over $20,000,000	$13,750, plus 32% of the excess over $75,000.
Over $20,000,000	$6,389,750, plus 35% of the excess over $20,000,000.

"(2) FOR TAXABLE YEARS BEGINNING IN 2009, 2010, OR 2011.—In the case of taxable years beginning in 2009, 2010, or 2011, the amount of the tax imposed by subsection (a) shall be determined in accordance with the following table:

"If taxable income is:	The tax is:
Not over $50,000	15% of taxable income.
Over $50,000 but not over $75,000	$7,500, plus 25% of the excess over $50,000.
Over $75,000 but not over $5,000,000	$13,750, plus 32% of the excess over $75,000.
Over $5,000,000 but not over $10,000,000	$1,589,750, plus 34% of the excess over $5,000,000.
Over $10,000,000	$3,289,750, plus 35% of the excess over $10,000,000.

"(3) FOR TAXABLE YEARS BEGINNING IN 2007 OR 2008.—In the case of taxable years beginning in 2007 or 2008, the amount of the tax imposed by subsection (a) shall be determined in accordance with the following table:

"If taxable income is:	The tax is:
Not over $50,000	15% of taxable income.
Over $50,000 but not over $75,000	$7,500, plus 25% of the excess over $50,000.
Over $75,000 but not over $1,000,000	$13,750, plus 32% of the excess over $75,000.
Over $1,000,000 but not over $10,000,000	$309,750, plus 34% of the excess over $1,000,000.
Over $10,000,000	$3,369,750, plus 35% of the excess over $10,000,000.

"(4) FOR TAXABLE YEARS BEGINNING IN 2004, 2005, OR 2006.—In the case of taxable years beginning in 2004, 2005, or 2006, the amount of the tax imposed by subsection (a) shall be determined in accordance with the following table:

"If taxable income is:	The tax is:
Not over $50,000	15% of taxable income.
Over $50,000 but not over $75,000	$7,500, plus 25% of the excess over $50,000.
Over $75,000 but not over $1,000,000	$13,750, plus 33% of the excess over $75,000.
Over $1,000,000 but not over $10,000,000	$319,000, plus 34% of the excess over $1,000,000.
Over $10,000,000	$3,379,000, plus 35% of the excess over $10,000,000.

"(5) PHASEOUT OF LOWER RATES FOR CERTAIN TAXPAYERS.—

"(A) GENERAL RULE FOR YEARS BEFORE 2012.—

"(i) IN GENERAL.—In the case of taxable years beginning before 2012 with respect to a corporation which has taxable income in excess of the applicable amount for any taxable year, the amount of tax determined under paragraph (1), (2), (3) or (4) for such taxable year shall be increased by the lesser of (I) 5 percent of such excess, or (II) the maximum increase amount.

"(ii) MAXIMUM INCREASE AMOUNT.—For purposes of clause (i)—

"In the case of any taxable year beginning during:	The applicable amount is:	The maximum increase amount is:
2004, 2005, or 2006	$1,000,000	$21,000
2007 or 2008	$1,000,000	$30,250
2009, 2010, or 2011	$5,000,000	$110,250.

"(B) HIGHER INCOME CORPORATIONS.—In the case of a corporation which has taxable income in excess of $20,000,000 ($15,000,000 in the case of taxable years beginning before 2012), the amount of the tax determined under the foregoing provisions of this subsection shall be increased by an additional amount equal to the lesser of (i) 3 percent of such excess, or (ii) $610,250 ($100,000 in the case of taxable years beginning before 2012).".

(b) CONFORMING AMENDMENTS.—

(1) Section 904(b)(3)(D)(ii) is amended to read as follows:

"(ii) in the case of a corporation, section 1201(a) applies to such taxable year.".

(2) Section 1201(a) is amended by striking "the last 2 sentences of section 11(b)(1)" and inserting "section 11(b)(5)".

(3) Section 1561(a) is amended—

(A) by striking "the last 2 sentences of section 11(b)(1)" and inserting "section 11(b)(5)", and

(B) by striking "such last 2 sentences" and inserting "section 11(b)(5)".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2003.

Subtitle B—Small Business Expensing

SEC. 1011. 2-YEAR EXTENSION OF INCREASED EXPENSING FOR SMALL BUSINESS.

Subsections (b), (c), and (d) of section 179 (as amended by the Jobs and Growth Tax Relief Reconciliation Act of 2003) are each amended by striking "2006" each place it appears and inserting "2008".

Subtitle C—Depreciation

SEC. 1021. RECOVERY PERIOD FOR DEPRECIATION OF CERTAIN LEASEHOLD IMPROVEMENTS AND RESTAURANT PROPERTY.

(a) 15-YEAR RECOVERY PERIOD.—Subparagraph (E) of section 168(e)(3) (relating to classification of certain property) is amended by striking "and" at the end of clause (ii), by striking the period at the end of clause (iii) and inserting a comma, and by adding at the end the following new clauses:

"(iv) any qualified leasehold improvement property placed in service before January 1, 2006, and

"(v) any qualified restaurant property placed in service before January 1, 2006."

(b) QUALIFIED LEASEHOLD IMPROVEMENT PROPERTY.—Subsection (e) of section 168 is amended by adding at the end the following new paragraph:

"(6) QUALIFIED LEASEHOLD IMPROVEMENT PROPERTY.—The term 'qualified leasehold improvement property' has the meaning given such term in section 168(k)(3) except that the following special rules shall apply:

"(A) IMPROVEMENTS MADE BY LESSOR.—In the case of an improvement made by the person who was the lessor of such improvement when such improvement was placed in service, such improvement shall be qualified leasehold improvement property (if at all) only so long as such improvement is held by such person.

"(B) EXCEPTION FOR CHANGES IN FORM OF BUSINESS.—Property shall not cease to be qualified leasehold improvement property under subparagraph (A) by reason of—

"(i) death,

"(ii) a transaction to which section 381(a) applies,

"(iii) a mere change in the form of conducting the trade or business so long as the property is retained in such trade or business as qualified leasehold improvement property and the taxpayer retains a substantial interest in such trade or business,

"(iv) the acquisition of such property in an exchange described in section 1031, 1033, or 1038 to the extent that the basis of such property includes an amount representing the adjusted basis of other property owned by the taxpayer or a related person, or

"(v) the acquisition of such property by the taxpayer in a transaction described in section 332, 351, 361, 721, or 731 (or the acquisition of such property by the taxpayer from the transferee or acquiring corporation in a transaction described in such section), to the extent that the basis of the property in the hands of the taxpayer is determined by reference to its basis in the hands of the transferor or distributor.".

(c) QUALIFIED RESTAURANT PROPERTY.—Subsection (e) of section 168 (as amended by subsection (b)) is further amended by adding at the end the following new paragraph:

"(7) QUALIFIED RESTAURANT PROPERTY.—The term 'qualified restaurant property' means any section 1250 property which is an improvement to a building if—

"(A) such improvement is placed in service more than 3 years after the date such building was first placed in service, and

"(B) more than 50 percent of the building's square footage is devoted to preparation of, and seating for on-premises consumption of, prepared meals.".

(d) REQUIREMENT TO USE STRAIGHT LINE METHOD.—

(1) Paragraph (3) of section 168(b) is amended by adding at the end the following new subparagraphs:

"(G) Qualified leasehold improvement property described in subsection (e)(6).

"(H) Qualified restaurant property described in subsection (e)(7).".

(2) Subparagraph (A) of section 168(b)(2) is amended by inserting before the comma "not referred to in paragraph (3)".

(e) ALTERNATIVE SYSTEM.—The table contained in section 168(g)(3)(B) is amended by adding at the end the following new items:

"(E)(iv)	39
"(E)(v)	39".

(f) EFFECTIVE DATE.—The amendments made by this section shall apply to property placed in service after the date of the enactment of this Act.

Subtitle D—Alternative Minimum Tax Relief

SEC. 1031. NET OPERATING LOSSES AND FOREIGN TAX CREDIT UNDER ALTERNATIVE MINIMUM TAX.

(a) NET OPERATING LOSSES.—

(1) IN GENERAL.—Subparagraph (A) of section 56(d)(1) is amended to read as follows:

"(A) the amount of such deduction shall not exceed the applicable percentage (determined under paragraph (3)) of the alternative minimum taxable income determined without regard to such deduction, and".

(2) APPLICABLE PERCENTAGE.—Subsection (d) of section 56 is amended by adding at the end the following new paragraph:

"(3) APPLICABLE PERCENTAGE.—For purposes of paragraph (1)(A)—

"For taxable years beginning in calendar year—	The applicable percentage is—
2005, 2006, or 2007	92
2008 or 2009	94
2010	96
2011	98
2012 or thereafter	100."

(b) FOREIGN TAX CREDIT.—

(1) Subsection (a) of section 59 is amended by striking paragraph (2) and by redesignating paragraphs (3) and (4) as paragraphs (2) and (3), respectively.

(2) Section 53(d)(1)(B)(i)(II) is amended by striking "and if section 59(a)(2) did not apply".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2004.

SEC. 1032. EXPANSION OF EXEMPTION FROM ALTERNATIVE MINIMUM TAX FOR SMALL CORPORATIONS.

(a) IN GENERAL.—Subparagraphs (A) and (B) of section 55(e)(1) are each amended by striking "$7,500,000" each place it appears and inserting "$20,000,000".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years beginning after December 31, 2004.

SEC. 1033. INCOME AVERAGING FOR FARMERS NOT TO INCREASE ALTERNATIVE MINIMUM TAX.

(a) IN GENERAL.—Subsection (c) of section 55 (defining regular tax) is amended by redesignating paragraph (2) as paragraph (3) and by inserting after paragraph (1) the following new paragraph:

"(2) COORDINATION WITH INCOME AVERAGING FOR FARMERS.—Solely for purposes of this section, section 1301 (relating to averaging of farm income) shall not apply in computing the regular tax liability.".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 2002.

Subtitle E—S Corporation Reform and Simplification

SEC. 1041. MEMBERS OF FAMILY TREATED AS 1 SHAREHOLDER.

(a) IN GENERAL.—Paragraph (1) of section 1361(c) (relating to special rules for applying subsection (b)) is amended to read as follows:

"(1) MEMBERS OF FAMILY TREATED AS 1 SHAREHOLDER.—

"(A) IN GENERAL.—For purpose of subsection (b)(1)(A)—

"(i) except as provided in clause (ii), a husband and wife (and their estates) shall be treated as 1 shareholder, and

"(ii) in the case of a family with respect to which an election is in effect under subparagraph (D), all members of the family shall be treated as 1 shareholder.

"(B) MEMBERS OF THE FAMILY.—For purpose of subparagraph (A)(ii)—

"(i) IN GENERAL.—The term 'members of the family' means the common ancestor, lineal descendants of the common ancestor, and the spouses (or former spouses) of such lineal descendants or common ancestor.

"(ii) COMMON ANCESTOR.—For purposes of this paragraph, an individual shall not be considered a common ancestor if, as of the later of the effective date of this paragraph or the time the election under section 1362(a) is made, the individual is more than 3 generations removed from the youngest generation of shareholders who would (but for this clause) be members of the family. For purposes of the preceding sentence, a spouse (or former spouse) shall be treated as being of the same generation as the individual to which such spouse is (or was) married.

"(C) EFFECT OF ADOPTION, ETC.—In determining whether any relationship specified in subparagraph (B) exists, the rules of section 152(b)(2) shall apply.

"(D) ELECTION.—An election under subparagraph (A)(ii)—

"(i) may, except as otherwise provided in regulations prescribed by the Secretary, be made by any member of the family, and

"(ii) shall remain in effect until terminated as provided in regulations prescribed by the Secretary.".

(b) RELIEF FROM INADVERTENT INVALID ELECTION OR TERMINATION.—Section 1362(f) (relating to inadvertent invalid elections or terminations), as amended by section 1049, is amended—

(1) by inserting "or section 1361(c)(1)(A)(ii)" after "section 1361(b)(3)(B)(ii)," in paragraph (1), and

(2) by inserting "or section 1361(c)(1)(D)(iii)" after "section 1361(b)(3)(C)," in paragraph (1)(B).

(c) EFFECTIVE DATES.—

(1) SUBSECTION (a).—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 2003.

(2) SUBSECTION (b).—The amendments made by subsection (b) shall apply to elections and terminations made after December 31, 2003.

SEC. 1042. INCREASE IN NUMBER OF ELIGIBLE SHAREHOLDERS TO 100.

(a) IN GENERAL.—Section 1361(b)(1)(A) (defining small business corporation) is amended by striking "75" and inserting "100".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years beginning after December 31, 2003.

SEC. 1043. EXPANSION OF BANK S CORPORATION ELIGIBLE SHAREHOLDERS TO INCLUDE IRAS.

(a) IN GENERAL.—Section 1361(c)(2)(A) (relating to certain trusts permitted as shareholders) is amended by inserting after clause (v) the following new clause:

"(vi) In the case of a corporation which is a bank (as defined in section 581), a trust which constitutes an individual retirement account under section 408(a), including one designated as a Roth IRA under section 408A, but only to the extent of the stock held by such trust in such bank as of the date of the enactment of this clause.".

(b) TREATMENT AS SHAREHOLDER.—Section 1361(c)(2)(B) (relating to treatment as shareholders) is amended by adding at the end the following new clause:

"(vi) In the case of a trust described in clause (vi) of subparagraph (A), the individual for whose benefit the trust was created shall be treated as a shareholder.".

(c) SALE OF BANK STOCK IN IRA RELATING TO S CORPORATION ELECTION EXEMPT FROM PROHIBITED TRANSACTION RULES.—Section 4975(d) (relating to exemptions) is amended by striking "or" at the end of paragraph (14), by striking the period at the end of paragraph (15) and inserting "; or", and by adding at the end the following new paragraph:

"(16) a sale of stock held by a trust which constitutes an individual retirement account under section 408(a) to the individual for whose benefit such account is established if—

"(A) such stock is in a bank (as defined in section 581),

"(B) such stock is held by such trust as of the date of the enactment of this paragraph,

"(C) such sale is pursuant to an election under section 1362(a) by such bank,

"(D) such sale is for fair market value at the time of sale (as established by an independent appraiser) and the terms of the sale are otherwise at least as favorable to such trust as the terms that would apply on a sale to an unrelated party,

"(E) such trust does not pay any commissions, costs, or other expenses in connection with the sale, and

"(F) the stock is sold in a single transaction for cash not later than 120 days after the S corporation election is made.".

(d) CONFORMING AMENDMENT.—Section 512(e)(1) is amended by inserting "1361(c)(2)(A)(vi) or" before "1361(c)(6)".

(e) EFFECTIVE DATE.—The amendments made by this section shall take effect on the date of the enactment of this Act.

SEC. 1044. DISREGARD OF UNEXERCISED POWERS OF APPOINTMENT IN DETERMINING POTENTIAL CURRENT BENEFICIARIES OF ESBT.

(a) IN GENERAL.—Section 1361(e)(2) (defining potential current beneficiary) is amended—

(1) by inserting "(determined without regard to any power of appointment to the extent such power remains unexercised at the end of such period)" after "of the trust" in the first sentence, and

(2) by striking "60-day" in the second sentence and inserting "1-year".

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2003.

SEC. 1045. TRANSFER OF SUSPENDED LOSSES INCIDENT TO DIVORCE, ETC.

(a) IN GENERAL.—Section 1366(d)(2) (relating to indefinite carryover of disallowed losses and deductions) is amended to read as follows:

"(2) INDEFINITE CARRYOVER OF DISALLOWED LOSSES AND DEDUCTIONS.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), any loss or deduction which is disallowed for any taxable year by reason of paragraph (1) shall be treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder.

"(B) TRANSFERS OF STOCK BETWEEN SPOUSES OR INCIDENT TO DIVORCE.—In the case of any transfer described in section 1041(a) of stock of an S corporation, any loss or deduction described in subparagraph (A) with respect such stock shall be treated as incurred by the corporation in the succeeding taxable year with respect to the transferee."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years beginning after December 31, 2003.

SEC. 1046. USE OF PASSIVE ACTIVITY LOSS AND AT-RISK AMOUNTS BY QUALIFIED SUBCHAPTER S TRUST INCOME BENEFICIARIES.

(a) IN GENERAL.—Section 1361(d)(1) (relating to special rule for qualified subchapter S trust) is amended—

(1) by striking "and" at the end of subparagraph (A),

(2) by striking the period at the end of subparagraph (B) and inserting ", and", and

(3) by adding at the end the following new subparagraph:

"(C) for purposes of applying sections 465 and 469 to the beneficiary of the trust, the disposition of the S corporation stock by the trust shall be treated as a disposition by such beneficiary.".

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to transfers made after December 31, 2003.

SEC. 1047. EXCLUSION OF INVESTMENT SECURITIES INCOME FROM PASSIVE INCOME TEST FOR BANK S CORPORATIONS.

(a) IN GENERAL.—Section 1362(d)(3) (relating to where passive investment income exceeds 25 percent of gross receipts for 3 consecutive taxable years and corporation has accumulated earnings and profits) is amended by adding at the end the following new subparagraph:

"(F) EXCEPTION FOR BANKS; ETC.—In the case of a bank (as defined in section 581), a bank holding company (within the meaning of section 2(a) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(a))), or a financial holding company (within the meaning of section 2(p) of such Act), the term 'passive investment income' shall not include—

"(i) interest income earned by such bank or company, or

"(ii) dividends on assets required to be held by such bank or company, including stock in the Federal Reserve Bank, the Federal Home Loan Bank, or the Federal Agricultural Mortgage Bank or participation certificates issued by a Federal Intermediate Credit Bank.".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years beginning after December 31, 2003.

SEC. 1048. TREATMENT OF BANK DIRECTOR SHARES.

(a) IN GENERAL.—Section 1361 (defining S corporation) is amended by adding at the end the following new subsection:

"(f) RESTRICTED BANK DIRECTOR STOCK.—

"(1) IN GENERAL.—Restricted bank director stock shall not be taken into account as outstanding stock of the S corporation in applying this subchapter (other than section 1368(f)).

"(2) RESTRICTED BANK DIRECTOR STOCK.—For purposes of this subsection, the term 'restricted bank director stock' means stock in a bank (as defined in section 581), a bank holding company (within the meaning of section 2(a) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(a))), or a financial holding company (within the meaning of section 2(p) of such Act), registered with the Federal Reserve System if such stock—

"(A) is required to be held by an individual under applicable Federal or State law in order to permit such individual to serve as a director, and

"(B) is subject to an agreement with such bank or company (or a corporation which controls (within the meaning of section 368(c)) such bank or company) pursuant to which the holder is required to sell back such stock (at the same price as the individual acquired such stock) upon ceasing to hold the office of director.

"(3) CROSS REFERENCE.—

"For treatment of certain distributions with respect to restricted bank director stock, see section 1368(f).".

(b) DISTRIBUTIONS.—Section 1368 (relating to distributions) is amended by adding at the end the following new subsection:

"(f) RESTRICTED BANK DIRECTOR STOCK.—If a director receives a distribution (not in part or full payment in exchange for stock) from an S corporation with respect to any restricted bank director stock (as defined in section 1361(f)), the amount of such distribution—

"(1) shall be includible in gross income of the director, and

"(2) shall be deductible by the corporation for the taxable year of such corporation in which or with which ends the taxable year in which such amount in included in the gross income of the director.".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2003.

SEC. 1049. RELIEF FROM INADVERTENTLY INVALID QUALIFIED SUBCHAPTER S SUBSIDIARY ELECTIONS AND TERMINATIONS.

(a) IN GENERAL.—Section 1362(f) (relating to inadvertent invalid elections or terminations) is amended—

(1) by inserting ", section 1361(b)(3)(B)(ii)," after "subsection (a)" in paragraph (1),

(2) by inserting ", section 1361(b)(3)(C)," after "subsection (d)" in paragraph (1)(B),

(3) by amending paragraph (3)(A) to read as follows:

"(A) so that the corporation for which the election was made is a small business corporation or a qualified subchapter S subsidiary, as the case may be, or",

(4) by amending paragraph (4) to read as follows:

"(4) the corporation for which the election was made, and each person who was a shareholder in such corporation at any time during the period specified pursuant to this subsection, agrees to make such adjustments (consistent with the treatment of such corporation as an S corporation or a qualified subchapter S subsidiary, as the case may be) as may be required by the Secretary with respect to such period,", and

(5) by inserting "or a qualified subchapter S subsidiary, as the case may be" after "S corporation" in the matter following paragraph (4).

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2003.

SEC. 1050. INFORMATION RETURNS FOR QUALIFIED SUBCHAPTER S SUBSIDIARIES.

(a) IN GENERAL.—Section 1361(b)(3)(A) (relating to treatment of certain wholly owned subsidiaries) is amended by inserting "and in the case of information returns required under part III of subchapter A of chapter 61" after "Secretary".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years beginning after December 31, 2003.

SEC. 1051. REPAYMENT OF LOANS FOR QUALIFYING EMPLOYER SECURITIES.

(a) IN GENERAL.—Subsection (f) of section 4975 (relating to other definitions and special rules) is amended by adding at the end the following new paragraph:

"(7) S CORPORATION REPAYMENT OF LOANS FOR QUALIFYING EMPLOYER SECURITIES.—A plan shall not be treated as violating the requirements of section 401 or 409 or subsection (e)(7), or as engaging in a prohibited transaction for purposes of subsection (d)(3), merely by reason of any distribution (as described in section 1368(a)) with respect to S corporation stock that constitutes qualifying employer securities, which in accordance with the plan provisions is used to make payments on a loan described in subsection (d)(3) the proceeds of which were used to acquire such qualifying employer securities (whether or not allocated to participants). The preceding sentence shall not apply in the case of a distribution which is paid with respect to any employer security which is allocated to a participant unless the plan provides that employer securities with a fair market value of not less than the amount of such distribution are allocated to such participant for the year which (but for the preceding sentence) such distribution would have been allocated to such participant.".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to distributions with respect to S corporation stock made after December 31, 2003.

Subtitle F—Protecting Employee Benefits

SEC. 1061. TREATMENT OF NONQUALIFIED DEFERRED COMPENSATION PLANS.

(a) IN GENERAL.—Subpart A of part I of subchapter D of chapter 1 is amended by adding at the end the following new section:

"SEC. 409A. INCLUSION IN GROSS INCOME OF DEFERRED COMPENSATION UNDER NONQUALIFIED DEFERRED COMPENSATION PLANS.

"(a) RULES RELATING TO CONSTRUCTIVE RECEIPT.—

"(1) IN GENERAL.—

"(A) GROSS INCOME INCLUSION.—In the case of a nonqualified deferred compensation plan, all compensation deferred under the plan for all taxable years (to the extent not subject to a substantial risk of forfeiture and not previously included in gross income) shall be includible in gross income for the taxable year unless at all times during the taxable year the plan meets the requirements of paragraphs (2), (3), and (4) and is operated in accordance with such requirements.

"(B) INTEREST ON TAX LIABILITY PAYABLE WITH RESPECT TO PREVIOUSLY DEFERRED COMPENSATION.—

"(i) IN GENERAL.—If compensation is required to be included in gross income under subparagraph (A) for a taxable year, the tax imposed by this chapter for such taxable year shall be increased by the amount of interest determined under clause (ii).

"(ii) INTEREST.—For purposes of clause (i), the interest determined under this clause for any taxable year is the amount of interest at the underpayment rate plus 1 percentage point on the underpayments that would have occurred had the deferred compensation been includible in gross income for the taxable year in which first deferred or, if later, the first taxable year in which such deferred compensation is not subject to a substantial risk of forfeiture.

"(2) DISTRIBUTIONS.—

"(A) IN GENERAL.—The requirements of this paragraph are met if the plan provides that compensation deferred under the plan may not be distributed earlier than—

"(i) separation from service as determined by the Secretary (except as provided in subparagraph (B)(i)),

"(ii) disability (as defined by section 223(d) of the Social Security Act),

"(iii) death,

"(iv) a specified time (or pursuant to a fixed schedule) specified under the plan at the date of the deferral of such compensation,

"(v) to the extent provided by the Secretary, a change in the ownership or effective control of the corporation, or in the ownership of a substantial portion of the assets of the corporation, or

"(vi) the occurrence of an unforeseeable emergency.

"(B) SPECIAL RULES.—

"(i) SPECIFIED EMPLOYEES.—In the case of specified employees, the requirement of subparagraph (A)(i) is met only if distributions may not be made earlier than 6 months after the date of separation from service. For purposes of the preceding sentence, a specified employee is a key employee (as defined in section 416(i)) of a corporation the stock in which is publicly traded on an established securities market or otherwise.

"(ii) UNFORESEEABLE EMERGENCY.—For purposes of subparagraph (A)(vi)—

"(I) IN GENERAL.—The term 'unforeseeable emergency' means a severe financial hardship to the participant resulting from a sudden and unexpected illness or accident of the participant, the participant's spouse, or a dependent (as defined in section 152(a)) of the participant, loss of the participant's property due to casualty, or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant.

"(II) LIMITATION ON DISTRIBUTIONS.—The requirement of subparagraph (A)(vi) is met only if, as determined under regulations of the Secretary, the amounts distributed with respect to an emergency do not exceed the amounts necessary to satisfy such emergency plus amounts necessary to pay taxes reasonably anticipated as a result of the distribution, after taking into account the extent to which such hardship is or may be relieved through reimbursement or compensation by insurance or otherwise or by liquidation of the participant's assets (to the extent the liquidation of such assets would not itself cause severe financial hardship).

"(3) ACCELERATION OF BENEFITS.—The requirements of this paragraph are met if the plan does not permit the acceleration of the time or schedule of any payment under the plan, except as provided in regulations by the Secretary.

"(4) ELECTIONS.—

"(A) IN GENERAL.—The requirements of this paragraph are met if the requirements of subparagraphs (B) and (C) are met.

"(B) INITIAL DEFERRAL DECISION.—The requirements of this subparagraph are met if the plan provides that compensation for services performed during a taxable year may be deferred at the participant's election only if the election to defer such compensation is made during the preceding taxable year or at such other time as provided in regulations. In the case of the first year in which a participant becomes eligible to participate in the plan, such election may be made with respect to services to be performed subsequent to the election within 30 days after the date the participant becomes eligible to participate in such plan.

"(C) CHANGES IN TIME AND FORM OF DISTRIBUTION.—The requirements of this subparagraph are met if, in the case of a plan which permits under a subsequent election a delay in a payment or a change in the form of payment—

"(i) the plan requires that such election may not take effect until at least 12 months after the date on which the election is made,

"(ii) in the case an election related to a payment not described in clause (ii), (iii), or (vi) of paragraph (2)(A), the plan requires that the first payment with respect to which such election is made be deferred for a period of not less than 5 years from the date such payment would otherwise have been made, and

"(iii) the plan requires that any election related to a payment described in paragraph (2)(A)(iv) may not be made less than 12 months prior to the date of the first scheduled payment under such paragraph.

"(b) RULES RELATING TO FUNDING.—

"(1) OFFSHORE PROPERTY IN A TRUST.—In the case of assets held in a trust or set aside (directly or indirectly) in another arrangement, as determined by the Secretary, for purposes of paying deferred compensation under a nonqualified deferred compensation plan, for purposes of section 83 such assets shall be treated as property transferred in connection with the performance of services whether or not such assets are available to satisfy claims of general creditors—

"(A) at the time set aside if such assets are located outside of the United States, or

"(B) at the time transferred if such assets are subsequently transferred outside of the United States.

"(2) EMPLOYER'S FINANCIAL HEALTH.—In the case of a nonqualified deferred compensation plan, there is a transfer of property within the meaning of section 83 as of the earlier of—

"(A) the date on which the plan first provides that assets will become restricted to the provision of benefits under the plan in connection with a change in the employer's financial health, or

"(B) the date on which assets are so restricted.

"(3) INCOME INCLUSION FOR OFFSHORE TRUSTS AND EMPLOYER'S FINANCIAL HEALTH.—For each taxable year that assets treated as transferred under this subsection remain set aside in a trust or other arrangement subject to paragraph (1) or (2), any increase in value in, or earnings with respect to, such assets shall be treated as an additional transfer of property under this subsection (to the extent not previously included in income).

"(4) INTEREST ON TAX LIABILITY PAYABLE WITH RESPECT TO TRANSFERRED PROPERTY.—

"(A) IN GENERAL.—If amounts are required to be included in gross income by reason of paragraph (1) or (2) for a taxable year, the tax imposed by this chapter for such taxable year shall be increased by the amount of interest determined under subparagraph (B).

"(B) INTEREST.—The interest determined under this subparagraph for any taxable year is the amount of interest at the underpayment rate plus 1 percentage point on the underpayments that would have occurred had the amounts so required to be included in gross income by paragraph (1) or (2) been includible in gross income for the taxable year in which such assets were first set aside (directly or indirectly) in a trust (or other arrangement determined by the Secretary) for purposes of the nonqualified deferred compensation plan.

"(c) NO INFERENCE ON EARLIER INCOME INCLUSION OR REQUIREMENT OF LATER INCLUSION.—Nothing in this section shall be construed to prevent the inclusion of amounts in gross income under any other provision of this chapter or any other rule of law earlier than the time provided in this section. Any amount included in gross income under this section shall not be required to be included in gross income under any other provision of this chapter or any other rule of law later than the time provided in this section.

"(d) OTHER DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

"(1) NONQUALIFIED DEFERRED COMPENSATION PLAN.—The term 'nonqualified deferred compensation plan' means any plan that provides for the deferral of compensation, other than—

"(A) a qualified employer plan, and

"(B) any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan.

"(2) QUALIFIED EMPLOYER PLAN.—The term 'qualified employer plan' means—

"(A) any plan, contract, pension, account, or trust described in subparagraph (A) or (B) of section 219(g)(5), and

"(B) any eligible deferred compensation plan (within the meaning of section 457(b)) of an employer described in section 457(e)(1)(A).

"(3) PLAN INCLUDES ARRANGEMENTS, ETC.—The term 'plan' includes any agreement or arrangement, including an agreement or arrangement that includes one person.

"(4) SUBSTANTIAL RISK OF FORFEITURE.—The rights of a person to compensation are subject to a substantial risk of forfeiture if such person's rights to such compensation are conditioned upon the future performance of substantial services by any individual.

"(5) TREATMENT OF EARNINGS.—References to deferred compensation shall be treated as including references to income (whether actual or notional) attributable to such compensation or such income.

"(e) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including regulations—

"(1) providing for the determination of amounts of deferral in the case of a nonqualified deferred compensation plan which is a defined benefit plan,

"(2) relating to changes in the ownership and control of a corporation or assets of a corporation for purposes of subsection (a)(2)(A)(v),

"(3) exempting arrangements from the application of subsection (b) if such arrangements will not result in an improper deferral of United States tax and will not result in assets being effectively beyond the reach of creditors,

"(4) defining financial health for purposes of subsection (b)(2), and

"(5) disregarding a substantial risk of forfeiture in cases where necessary to carry out the purposes of this section.".

(b) W–2 FORMS.—

(1) IN GENERAL.—Subsection (a) of section 6051 (relating to receipts for employees) is amended by striking "and" at the end of paragraph (10), by striking the period at the end of paragraph (11) and inserting ", and", and by inserting after paragraph (11) the following new paragraph:

"(12) the total amount of deferrals under a nonqualified deferred compensation plan (within the meaning of section 409A(d)).".

(2) THRESHOLD.—Subsection (a) of section 6051 is amended by adding at the end the following: "In the case of the amounts required to be shown by paragraph (12), the Secretary (by regulation) may establish a minimum amount of deferrals below which paragraph (12) does not apply and may provide that paragraph (12) does not apply with respect to amounts of deferrals which are not reasonably ascertainable.".

(c) CONFORMING AND CLERICAL AMENDMENTS.—

(1) Section 414(b) is amended by inserting "409A," after "408(p),".

(2) Section 414(c) is amended by inserting "409A," after "408(p),".

(3) The table of sections for such subpart A of part I of subchapter D of chapter 1 is amended by adding at the end the following new item:

"Sec. 409A. Inclusion in gross income of deferred compensation under nonqualified deferred compensation plans.".

(d) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall apply to amounts deferred in taxable years beginning after December 31, 2003.

(2) AMOUNTS DEFERRED IN 2004 UNDER CERTAIN IRREVOCABLE ELECTIONS AND BINDING ARRANGEMENTS.—The amendments made by this section shall not apply to amounts deferred in taxable years beginning after December 31, 2003, and before January 1, 2005, pursuant to an irrevocable election or binding arrangement made before October 24, 2003.

(3) EARNINGS ATTRIBUTABLE TO AMOUNT PREVIOUSLY DEFERRED.—The amendments made by this section shall apply to earnings on deferred compensation only to the extent that such amendments apply to such compensation.

(e) GUIDANCE RELATING TO CHANGE OF OWNERSHIP OR CONTROL.—Not later than 90 days after the date of the enactment of this Act, the Secretary of the Treasury shall issue guidance on what constitutes a change in ownership or effective control for purposes of section 409A of the Internal Revenue Code of 1986, as added by this section.

(f) GUIDANCE RELATING TO TERMINATION OF CERTAIN EXISTING ARRANGEMENTS.—Not later than 90 days after the date of the enactment of this Act, the Secretary of the Treasury shall issue guidance providing a limited period during which an individual participating in a nonqualified deferred compensation plan adopted on or before December 31, 2003, may, without violating the requirements of paragraphs (2), (3), and (4) of section 409A(a)(2) of the Internal Revenue Code of 1986 (as added by this section), terminate participation or cancel an outstanding deferral election with regard to amounts earned after December 31, 2003, if such amounts are includible in income as earned.

SEC. 1062. EXCLUSION OF INCENTIVE STOCK OPTIONS AND EMPLOYEE STOCK PURCHASE PLAN STOCK OPTIONS FROM WAGES.

(a) EXCLUSION FROM EMPLOYMENT TAXES.—

(1) SOCIAL SECURITY TAXES.—

(A) Section 3121(a) (relating to definition of wages) is amended by striking "or" at the end of paragraph (20), by striking the period at the end of paragraph (21) and inserting "; or", and by inserting after paragraph (21) the following new paragraph:

"(22) remuneration on account of—

"(A) a transfer of a share of stock to any individual pursuant to an exercise of an incentive stock option (as defined in section 422(b)) or under an employee stock purchase plan (as defined in section 423(b)), or

"(B) any disposition by the individual of such stock.".

(B) Section 209(a) of the Social Security Act is amended by striking "or" at the end of paragraph (17), by striking the period at the end of paragraph (18) and inserting "; or", and by inserting after paragraph (18) the following new paragraph:

"(19) Remuneration on account of—

"(A) a transfer of a share of stock to any individual pursuant to an exercise of an incentive stock option (as defined in section 422(b) of the Internal Revenue Code of 1986) or under an employee stock purchase plan (as defined in section 423(b) of such Code), or

"(B) any disposition by the individual of such stock.".

(2) RAILROAD RETIREMENT TAXES.—Subsection (e) of section 3231 is amended by adding at the end the following new paragraph:

"(11) QUALIFIED STOCK OPTIONS.—The term 'compensation' shall not include any remuneration on account of—

"(A) a transfer of a share of stock to any individual pursuant to an exercise of an incentive stock option (as defined in section 422(b)) or under an employee stock purchase plan (as defined in section 423(b)), or

"(B) any disposition by the individual of such stock.".

(3) UNEMPLOYMENT TAXES.—Section 3306(b) (relating to definition of wages) is amended by striking "or" at the end of paragraph (16), by striking the period at the end of paragraph (17) and inserting "; or", and by inserting after paragraph (17) the following new paragraph:

"(18) remuneration on account of—

"(A) a transfer of a share of stock to any individual pursuant to an exercise of an incentive stock option (as defined in section 422(b)) or under an employee stock purchase plan (as defined in section 423(b)), or

"(B) any disposition by the individual of such stock.".

(b) WAGE WITHHOLDING NOT REQUIRED ON DISQUALIFYING DISPOSITIONS.—Section 421(b) (relating to effect of disqualifying dispositions) is amended by adding at the end the following new sentence: "No amount shall be required to be deducted and withheld under chapter 24 with respect to any increase in income attributable to a disposition described in the preceding sentence.".

(c) WAGE WITHHOLDING NOT REQUIRED ON COMPENSATION WHERE OPTION PRICE IS BETWEEN 85 PERCENT AND 100 PERCENT OF VALUE OF STOCK.—Section 423(c) (relating to special rule where option price is between 85 percent and 100 percent of value of stock) is amended by adding at the end the following new sentence: "No amount shall be required to be deducted and withheld under chapter 24 with respect to any amount treated as compensation under this subsection.".

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to stock acquired pursuant to options exercised after the date of the enactment of this Act.

SEC. 1063. EXTENSION OF TRANSFERS OF EXCESS PENSION ASSETS TO RETIREE HEALTH ACCOUNTS.

Paragraph (5) of section 420(b) (relating to expiration) is amended by striking "December 31, 2005" and inserting "December 31, 2013".

Subtitle G—Treatment of Active Income

SEC. 1071. MEMBER STATES OF THE EUROPEAN UNION TREATED AS A SINGLE COUNTRY FOR CERTAIN PURPOSES.

(a) IN GENERAL.—Subsection (d) of section 954 is amended by adding at the end the following new paragraph:

"(5) TREATMENT OF MEMBER STATES OF THE EUROPEAN UNION.—For purposes of this subsection and subsection (e), in the case of a controlled foreign corporation which is created or organized under the laws of a member state of the European Union, all member states of the European Union shall be treated as 1 country.".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years of foreign corporations beginning after December 31, 2008, and to taxable years of United States shareholders with or within which such taxable years of foreign corporations end.

SEC. 1072. LOOK-THRU TREATMENT OF PAYMENTS BETWEEN RELATED CONTROLLED FOREIGN CORPORATIONS UNDER FOREIGN PERSONAL HOLDING COMPANY INCOME RULES.

(a) IN GENERAL.—Subsection (c) of section 954 is amended by adding after paragraph (3) the following new paragraph:

"(4) LOOK-THRU IN THE CASE OF RELATED CONTROLLED FOREIGN CORPORATIONS.—For purposes of this subsection, dividends, interest, rents, and royalties received or accrued from a controlled foreign corporation which is a related person (as defined in subsection (d)(3)) shall not be treated as foreign personal holding company income to the extent attributable or properly allocable (determined under rules similar to the rules of subparagraphs (C) and (D) of section 904(d)(3)) to income of the related person which is not subpart F income (as defined in section 952). The Secretary shall prescribe such regulations as may be appropriate to prevent the abuse of the purposes of this paragraph."

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years of foreign corporations beginning after December 31, 2006, and to taxable years of United States shareholders with or within which such taxable years of foreign corporations end.

SEC. 1073. LOOK-THRU TREATMENT FOR SALES OF PARTNERSHIP INTERESTS.

(a) IN GENERAL.—Section 954(c) (defining foreign personal holding company income) is amended by adding after paragraph (4) the following new paragraph:

"(5) LOOK-THRU RULE FOR CERTAIN PARTNERSHIP SALES.—

"(A) IN GENERAL.—In the case of any sale by a controlled foreign corporation of an interest in a partnership with respect to which such corporation is a 25-percent owner, such corporation shall be treated for purposes of this subsection as selling the proportionate share of the assets of the partnership attributable to such interest.

"(B) 25-PERCENT OWNER.—For purposes of this paragraph, the term '25-percent owner' means a controlled foreign corporation which owns (within the meaning of section 958(a)) 25 percent or more of the capital or profits interest in the partnership."

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years of foreign corporations beginning after December 31, 2006, and to taxable years of United States shareholders with or within which such taxable years of foreign corporations end.

SEC. 1074. REPEAL OF FOREIGN PERSONAL HOLDING COMPANY RULES AND FOREIGN INVESTMENT COMPANY RULES.

(a) GENERAL RULE.—The following provisions are hereby repealed:

(1) Part III of subchapter G of chapter 1 (relating to foreign personal holding companies).

(2) Section 1246 (relating to gain on foreign investment company stock).

(3) Section 1247 (relating to election by foreign investment companies to distribute income currently).

(b) EXEMPTION OF FOREIGN CORPORATIONS FROM PERSONAL HOLDING COMPANY RULES.—

(1) IN GENERAL.—Subsection (c) of section 542 (relating to exceptions) is amended—

(A) by striking paragraph (5) and inserting the following:

"(5) a foreign corporation,",

(B) by striking paragraphs (7) and (10) and by redesignating paragraphs (8) and (9) as paragraphs (7) and (8), respectively,

(C) by inserting "and" at the end of paragraph (7) (as so redesignated), and

(D) by striking "; and" at the end of paragraph (8) (as so redesignated) and inserting a period.

(2) TREATMENT OF INCOME FROM PERSONAL SERVICE CONTRACTS.—Paragraph (1) of section 954(c) is amended by adding at the end the following new subparagraph:

"(H) PERSONAL SERVICE CONTRACTS.—

"(i) Amounts received under a contract under which the corporation is to furnish personal services if—

"(I) some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or

"(II) the individual who is to perform the services is designated (by name or by description) in the contract, and

"(ii) amounts received from the sale or other disposition of such a contract.

This subparagraph shall apply with respect to amounts received for services under a particular contract only if at some time during the taxable year 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the individual who has performed, is to perform, or may be designated (by name or by description) as the one to perform, such services."

(c) CONFORMING AMENDMENTS.—

(1) Clause (iii) of section 1(h)(11)(C) is amended by striking "a foreign personal holding company (as defined in section 552), a foreign investment company (as defined in section 1246(b)), or".

(2) Paragraph (2) of section 171(c) is amended—

(A) by striking ", or by a foreign personal holding company, as defined in section 552", and

(B) by striking "or foreign personal holding company".

(3) Paragraph (2) of section 245(a) is amended by striking "foreign personal holding company or".

(4) Section 312 is amended by striking subsection (j).

(5) Subsection (m) of section 312 is amended by striking ", a foreign investment company (within the meaning of section 1246(b)), or a foreign personal holding company (within the meaning of section 552)".

(6) Subsection (e) of section 443 is amended by striking paragraph (3) and by redesignating paragraphs (4) and (5) as paragraphs (3) and (4), respectively.

(7) Subparagraph (B) of section 465(c)(7) is amended by adding "or" at the end of clause (i), by striking clause (ii), and by redesignating clause (iii) as clause (ii).

(8) Paragraph (1) of section 543(b) is amended by inserting "and" at the end of subparagraph (A), by striking ", and" at the end of subparagraph (B) and inserting a period, and by striking subparagraph (C).

(9) Paragraph (1) of section 562(b) is amended by striking "or a foreign personal holding company described in section 552".

(10) Section 563 is amended—

(A) by striking subsection (c),

(B) by redesignating subsection (d) as subsection (c), and

(C) by striking "subsection (a), (b), or (c)" in subsection (c) (as so redesignated) and inserting "subsection (a) or (b)".

(11) Subsection (d) of section 751 is amended by adding "and" at the end of paragraph (2), by striking paragraph (3), by redesignating paragraph (4) as paragraph (3), and by striking "paragraph (1), (2), or (3)" in paragraph (3) (as so redesignated) and inserting "paragraph (1) or (2)".

(12) Paragraph (2) of section 864(d) is amended by striking subparagraph (A) and by redesignating subparagraphs (B) and (C) as subparagraphs (A) and (B), respectively.

(13)(A) Subparagraph (A) of section 898(b)(1) is amended to read as follows:

"(A) which is treated as a controlled foreign corporation for any purpose under subpart F of part III of this subchapter, and".

(B) Subparagraph (B) of section 898(b)(2) is amended by striking "and sections 551(f) and 554, whichever are applicable,".

(C) Paragraph (3) of section 898(b) is amended to read as follows:

"(3) UNITED STATES SHAREHOLDER.—The term 'United States shareholder' has the meaning given to such term by section 951(b), except that, in the case of a foreign corporation having related person insurance income (as defined in section 953(c)(2)), the Secretary may treat any person as a United States shareholder for purposes of this section if such person is treated as a United States shareholder under section 953(c)(1).”

(D) Subsection (c) of section 898 is amended to read as follows:

“(c) DETERMINATION OF REQUIRED YEAR.—

“(1) IN GENERAL.—The required year is—

“(A) the majority U.S. shareholder year, or

“(B) if there is no majority U.S. shareholder year, the taxable year prescribed under regulations.

“(2) 1-MONTH DEFERRAL ALLOWED.—A specified foreign corporation may elect, in lieu of the taxable year under paragraph (1)(A), a taxable year beginning 1 month earlier than the majority U.S. shareholder year.

“(3) MAJORITY U.S. SHAREHOLDER YEAR.—

“(A) IN GENERAL.—For purposes of this subsection, the term ‘majority U.S. shareholder year’ means the taxable year (if any) which, on each testing day, constituted the taxable year of—

“(i) each United States shareholder described in subsection (b)(2)(A), and

“(ii) each United States shareholder not described in clause (i) whose stock was treated as owned under subsection (b)(2)(B) by any shareholder described in such clause.

“(B) TESTING DAY.—The testing days shall be—

“(i) the first day of the corporation’s taxable year (determined without regard to this section), or

“(ii) the days during such representative period as the Secretary may prescribe.”

(14) Clause (ii) of section 904(d)(2)(A) is amended to read as follows:

“(ii) CERTAIN AMOUNTS INCLUDED.—Except as provided in clause (iii), the term ‘passive income’ includes, except as provided in subparagraph (E)(iii) or paragraph (3)(I), any amount includible in gross income under section 1293 (relating to certain passive foreign investment companies).”

(15)(A) Subparagraph (A) of section 904(g)(1) is amended by adding “or” at the end of clause (i), by striking clause (ii), and by redesignating clause (iii) as clause (ii).

(B) The paragraph heading of paragraph (2) of section 904(g) is amended by striking “FOREIGN PERSONAL HOLDING OR”.

(16) Section 951 is amended by striking subsections (c) and (d) and by redesignating subsections (e) and (f) as subsections (c) and (d), respectively.

(17) Paragraph (3) of section 989(b) is amended by striking “, 551(a),”.

(18) Paragraph (5) of section 1014(b) is amended by inserting “and before January 1, 2008,” after “August 26, 1937,”.

(19) Subsection (a) of section 1016 is amended by striking paragraph (13).

(20)(A) Paragraph (3) of section 1212(a) is amended to read as follows:

“(3) SPECIAL RULES ON CARRYBACKS.—A net capital loss of a corporation shall not be carried back under paragraph (1)(A) to a taxable year—

“(A) for which it is a regulated investment company (as defined in section 851), or

“(B) for which it is a real estate investment trust (as defined in section 856).”

(B) The amendment made by subparagraph (A) shall apply to taxable years beginning after December 31, 2006.

(21) Section 1223 is amended by striking paragraph (10) and by redesignating the following paragraphs accordingly.

(22) Subsection (d) of section 1248 is amended by striking paragraph (5) and by redesignating paragraphs (6) and (7) as paragraphs (5) and (6), respectively.

(23) Paragraph (2) of section 1260(c) is amended by striking subparagraphs (H) and (I) and by redesignating subparagraph (J) as subparagraph (H).

(24)(A) Subparagraph (F) of section 1291(b)(3) is amended by striking “551(d), 959(a),” and inserting “959(a)”.

(B) Subsection (e) of section 1291 is amended by inserting “(as in effect on the day before the date of the enactment of the American Jobs Creation Act of 2003)” after “section 1246”.

(25) Paragraph (2) of section 1294(a) is amended to read as follows:

“(2) ELECTION NOT PERMITTED WHERE AMOUNTS OTHERWISE INCLUDIBLE UNDER SECTION 951.—The taxpayer may not make an election under paragraph (1) with respect to the undistributed PFIC earnings tax liability attributable to a qualified electing fund for the taxable year if any amount is includible in the gross income of the taxpayer under section 951 with respect to such fund for such taxable year.”

(26) Section 6035 is hereby repealed.

(27) Subparagraph (D) of section 6103(e)(1) is amended by striking clause (iv) and redesignating clauses (v) and (vi) as clauses (iv) and (v), respectively.

(28) Subparagraph (B) of section 6501(e)(1) is amended to read as follows:

"(B) CONSTRUCTIVE DIVIDENDS.—If the taxpayer omits from gross income an amount properly includible therein under section 951(a), the tax may be assessed, or a proceeding in court for the collection of such tax may be done without assessing, at any time within 6 years after the return was filed."

(29) Subsection (a) of section 6679 is amended—

(A) by striking "6035, 6046, or 6046A" in paragraph (1) and inserting "6046 or 6046A", and

(B) by striking paragraph (3).

(30) Sections 170(f)(10)(A), 508(d), 4947, and 4948(c)(4) are each amended by striking "556(b)(2)," each place it appears.

(31) The table of parts for subchapter G of chapter 1 is amended by striking the item relating to part III.

(32) The table of sections for part IV of subchapter P of chapter 1 is amended by striking the items relating to sections 1246 and 1247.

(33) The table of sections for subpart A of part III of subchapter A of chapter 61 is amended by striking the item relating to section 6035.

(34) Sections 163(e)(3)(B)(i) and 267(a)(3)(B)(i) are each amended by—

(A) striking "a foreign personal holding company (as defined in section 552),", and

(B) striking the comma after "(as defined in section 957)".

(d) EFFECTIVE DATE.—Except as otherwise provided in this section, the amendments made by this section shall apply to taxable years of foreign corporations beginning after December 31, 2006, and to taxable years of United States shareholders with or within which such taxable years of foreign corporations end.

SEC. 1075. CLARIFICATION OF TREATMENT OF PIPELINE TRANSPORTATION INCOME.

(a) IN GENERAL.—Section 954(g)(1) (defining foreign base company oil related income) is amended by striking "or" at the end of subparagraph (A), by striking the period at the end of subparagraph (B) and inserting ", or", and by inserting after subparagraph (B) the following new subparagraph:

"(C) the pipeline transportation of oil or gas within such foreign country."

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years of foreign corporations beginning after December 31, 2004, and to taxable years of United States shareholders with or within which such taxable years of foreign corporations end.

SEC. 1076. DETERMINATION OF FOREIGN PERSONAL HOLDING COMPANY INCOME WITH RESPECT TO TRANSACTIONS IN COMMODITIES.

(a) IN GENERAL.—Clauses (i) and (ii) of section 954(c)(1)(C) (relating to commodity transactions) are amended to read as follows:

"(i) arise out of commodity hedging transactions (as defined in paragraph (6)(A)),

"(ii) are active business gains or losses from the sale of commodities, but only if substantially all of the controlled foreign corporation's commodities are property described in paragraph (1), (2), or (8) of section 1221(a), or".

(b) DEFINITION AND SPECIAL RULES.—Subsection (c) of section 954 is amended by adding after paragraph (5) the following new paragraph:

"(6) DEFINITION AND SPECIAL RULES RELATING TO COMMODITY TRANSACTIONS.—

"(A) COMMODITY HEDGING TRANSACTIONS.—For purposes of paragraph (1)(C)(i), the term 'commodity hedging transaction' means any transaction with respect to a commodity if such transaction—

"(i) is a hedging transaction as defined in section 1221(b)(2), determined—

"(I) without regard to subparagraph (A)(ii) thereof,

"(II) by applying subparagraph (A)(i) thereof by substituting 'ordinary property or property described in section 1231(b)' for 'ordinary property', and

"(III) by substituting 'controlled foreign corporation' for 'taxpayer' each place it appears, and

"(ii) is clearly identified as such in accordance with section 1221(a)(7).

"(B) REGULATIONS.—The Secretary shall prescribe such regulations as are appropriate to carry out the purposes of paragraph (1)(C) in the case of transactions involving related persons."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to transactions entered into after December 31, 2004.

SEC. 1077. REPEAL OF CFC RULES ON FOREIGN BASE COMPANY SHIPPING INCOME.

(a) ELIMINATION OF FOREIGN BASE COMPANY SHIPPING INCOME.—Section 954 (relating to foreign base company income) is amended—

(1) by striking paragraph (4) of subsection (a) (relating to foreign base company shipping income), and

(2) by striking subsection (f) (relating to foreign base company shipping income).

(b) SAFE HARBOR FOR CERTAIN LEASING ACTIVITIES.—Subparagraph (A) of section 954(c)(2) is amended by adding at the end the following new sentence: "For purposes of the preceding sentence, rents derived from leasing an aircraft or vessel in foreign commerce shall not fail to be treated as derived in the active conduct of a trade or business if, as determined under regulations prescribed by the Secretary, the active leasing expenses are not less than 10 percent of the profit on the lease."

(c) CONFORMING AMENDMENTS.—

(1) Section 952(c)(1)(B)(iii) is amended by striking subclause (I) and redesignating subclauses (II) through (VI) as subclauses (I) through (V), respectively.

(2) Subsection (b) of section 954 is amended—

(A) by striking "the foreign base company shipping income," in paragraph (5),

(B) by striking paragraphs (6) and (7), and

(C) by redesignating paragraph (8) as paragraph (6).

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years of foreign corporations beginning after December 31, 2004, and to taxable years of United States shareholders with or within which such taxable years of foreign corporations end.

SEC. 1078. MODIFICATION OF SUBPART F EXEMPTION FOR ACTIVE FINANCING.

(a) IN GENERAL.—Section 954(h)(3) is amended by adding at the end the following:

"(E) DIRECT CONDUCT OF ACTIVITIES.—For purposes of subparagraph (A)(ii)(II), an activity shall be treated as conducted directly by an eligible controlled foreign corporation or qualified business unit in its home country if the activity is performed by employees of a related person and—

"(i) the related person is an eligible controlled foreign corporation the home country of which is the same as the home country of the corporation or unit to which subparagraph (A)(ii)(II) is being applied,

"(ii) the activity is performed in the home country of the related person, and

"(iii) the related person is compensated on an arm's-length basis for the performance of the activity by its employees and such compensation is treated as earned by such person in its home country for purposes of the home country's tax laws.".

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years of foreign corporations beginning after December 31, 2004, and to taxable years of United States shareholders with or within which such taxable years of foreign corporations end.

SEC. 1079. PARTIAL EXCLUSION FOR INCOME ATTRIBUTABLE TO FILMS USED OUTSIDE THE UNITED STATES.

(a) IN GENERAL.—Part III of subchapter B of chapter 1 (relating to items specifically excluded from gross income) is amended by inserting after section 139 the following new section:

"SEC. 139A. INCOME ATTRIBUTABLE TO FILMS USED OUTSIDE THE UNITED STATES.

"(a) EXCLUSION.—

"(1) IN GENERAL.—There shall be excluded from gross income an amount equal to the applicable percentage of qualified film income.

"(2) APPLICABLE PERCENTAGE.—For purposes of paragraph (1), the applicable percentage shall be determined in accordance with the following table:

"For taxable years ending in calendar year—	The applicable percentage is—
2007	1
2008	2
2009	3
2010	5
2011	8
2012	9
2013 or thereafter	10.

"(b) QUALIFIED FILM INCOME.—For purposes of this section—

"(1) IN GENERAL.—The term 'qualified film income' means gross income from a license of a qualified film in the ordinary course of a trade or business for the exploitation or direct use outside the United States less any associated film costs.

"(2) EXCEPTIONS.—

"(A) CERTAIN USES.—Such term does not include exploitation of characters, soundtracks, designs, scripts, scores, or any other ancillary intangibles associated with the qualified film.

"(B) RELATED PERSON LICENSE.—

"(i) IN GENERAL.—Such term does not include any amount from the license of a qualified film to a related person.

"(ii) EXCEPTION.—Clause (i) shall not apply if such film is held for license by such related person to an unrelated person for the direct use or exploitation by such unrelated person outside the United States.

"(iii) RELATED PERSON.—For purposes of this subparagraph, a person shall be related to another person if such persons are treated as a single employer under subsection (a) or (b) of section 52 or subsection (m) or (o) of section 414, except that determinations under subsections (a) and (b) of section 52 shall be made without regard to section 1563(b).

"(c) OTHER DEFINITIONS.—For purposes of this section—

"(1) QUALIFIED FILM.—The term 'qualified film' means property described in section 168(f)(3) the original use of which commences after December 31, 2006, if not less than 50 percent of the total compensation relating to the production of such property is compensation for services performed in the United States by actors, production personnel, directors, and producers. Such term does not include property with respect to which records are required to be maintained under section 2257 of title 18, United States Code.

"(2) ASSOCIATED FILM COSTS.—The term 'associated film costs' means any expense properly apportioned and allocated to income taken into account under subsection (b)(1), determined as provided under regulations prescribed by the Secretary.

"(d) ELECTION.—The taxpayer may elect not to apply this section to a qualified film. Such election shall be made by the due date (including extensions of time) for filing the return for the taxable year in which such film is placed in service, and, once made for such film, such election shall be irrevocable.

"(e) DENIAL OF FOREIGN TAX CREDIT.—

"(1) IN GENERAL.—No credit shall be allowed under section 901 for any taxes paid or accrued (or treated as paid or accrued) with respect to the excludable portion of any qualified film income. No deduction shall be allowed under this chapter for any tax for which credit is not allowable by reason of the preceding sentence.

"(2) EXCLUDABLE PORTION.—For purposes of paragraph (1), the taxes paid or accrued (or treated as paid or accrued) with respect to the excludable portion is the amount which bears the same ratio to the amount of taxes paid or accrued (or treated as paid or accrued) with respect to qualified film income as the amount excluded under subsection (a) for the taxable year bears to the qualified film income for such year.".

(b) CLERICAL AMENDMENT.—The table of sections for part III of subchapter B of chapter 1 is amended by inserting after the item relating to section 139 the following new item:

"Sec. 139A. Income attributable to films used outside the United States.".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years ending after December 31, 2006.

Subtitle H—Reduction of Double Taxation of Earnings

SEC. 1081. INTEREST EXPENSE ALLOCATION RULES.

(a) ELECTION TO ALLOCATE ON WORLDWIDE BASIS.— Section 864 is amended by redesignating subsection (f) as subsection (g) and by inserting after subsection (e) the following new subsection:

"(f) ELECTION TO ALLOCATE INTEREST, ETC. ON WORLDWIDE BASIS.—For purposes of this subchapter, at the election of the worldwide affiliated group—

"(1) ALLOCATION AND APPORTIONMENT OF INTEREST EXPENSE.—

"(A) IN GENERAL.—The taxable income of each domestic corporation which is a member of a worldwide affiliated group shall be determined by allocating and apportioning interest expense of each member as if all members of such group were a single corporation.

"(B) TREATMENT OF WORLDWIDE AFFILIATED GROUP.—The taxable income of the domestic members of a worldwide affiliated group from sources outside the United States shall be determined by allocating and apportioning the interest expense of such domestic members to such income in an amount equal to the excess (if any) of—

"(i) the total interest expense of the worldwide affiliated group multiplied by the ratio which the foreign assets of the worldwide affiliated group bears to all the assets of the worldwide affiliated group, over

"(ii) the interest expense of all foreign corporations which are members of the worldwide affiliated group to the extent such interest expense of such foreign corporations would have been allocated and apportioned to foreign source income if this subsection were applied to a group consisting of all the foreign corporations in such worldwide affiliated group.

"(C) WORLDWIDE AFFILIATED GROUP.—For purposes of this paragraph, the term 'worldwide affiliated group' means a group consisting of—

"(i) the includible members of an affiliated group (as defined in section 1504(a), determined without regard to paragraphs (2) and (4) of section 1504(b)), and

"(ii) all controlled foreign corporations in which such members in the aggregate meet the ownership requirements of section 1504(a)(2) either directly or indirectly through applying paragraph (2) of section 958(a) or through applying rules similar to the rules of such paragraph to stock owned directly or indirectly by domestic partnerships, trusts, or estates.

"(2) ALLOCATION AND APPORTIONMENT OF OTHER EXPENSES.—Expenses other than interest which are not directly allocable or apportioned to any specific income producing activity shall be allocated and apportioned as if all members of the affiliated group were a single corporation. For purposes of the preceding sentence, the term 'affiliated group' has the meaning given such term by section 1504 (determined without regard to paragraph (4) of section 1504(b)).

"(3) TREATMENT OF TAX-EXEMPT ASSETS; BASIS OF STOCK IN NONAFFILIATED 10-PERCENT OWNED CORPORATIONS.—The rules of paragraphs (3) and (4) of subsection (e) shall apply for purposes of this subsection; except that paragraph (4) shall be applied on worldwide affiliated group basis.

"(4) TREATMENT OF CERTAIN FINANCIAL INSTITUTIONS.—

"(A) IN GENERAL.—For purposes of paragraph (1), any corporation described in subparagraph (B) shall be treated as an includible corporation for purposes of section 1504 only for purposes of applying this subsection separately to corporations so described.

"(B) DESCRIPTION.—A corporation is described in this subparagraph if—

"(i) such corporation is a financial institution described in section 581 or 591,

"(ii) the business of such financial institution is predominantly with persons other than related persons (within the meaning of subsection (d)(4)) or their customers, and

"(iii) such financial institution is required by State or Federal law to be operated separately from any other entity which is not such an institution.

"(C) TREATMENT OF BANK HOLDING COMPANIES.—To the extent provided in regulations—

"(i) a bank holding company (within the meaning of section 2(a) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(a))),

"(ii) a financial holding company (within the meaning of section 2(p) of such Act), and

"(iii) any subsidiary of a financial institution described in section 581 or 591, or any such bank or financial holding company, if such subsidiary is predominantly engaged (directly or indirectly) in the active conduct of a banking, financing, or similar business,

shall be treated as a corporation described in subparagraph (B).

"(5) ELECTION TO EXPAND FINANCIAL INSTITUTION GROUP OF WORLDWIDE GROUP.—

"(A) IN GENERAL.—If a worldwide affiliated group elects the application of this subsection, all financial corporations which—

"(i) are members of such worldwide affiliated group, but

"(ii) are not corporations described in paragraph (4)(B), shall be treated as described in paragraph (4)(B) for purposes of applying paragraph (4)(A). This subsection (other than this paragraph) shall apply to any such group in the same manner as this subsection (other than this paragraph) applies to the pre-election worldwide affiliated group of which such group is a part.

"(B) FINANCIAL CORPORATION.—For purposes of this paragraph, the term 'financial corporation' means any corporation if at least 80 percent of its gross income is income described in section 904(d)(2)(D)(ii) and the regulations thereunder which is derived from transactions with persons who are not related (within the meaning of section 267(b) or 707(b)(1)) to the corporation. For purposes of the preceding sentence, there shall be disregarded any item of income or gain from a transaction or series of transactions a principal purpose of which is the qualification of any corporation as a financial corporation.

"(C) ANTIABUSE RULES.—In the case of a corporation which is a member of an electing financial institution group, to the extent that such corporation—

"(i) distributes dividends or makes other distributions with respect to its stock after the date of the enactment of this paragraph to any member of the pre-election worldwide affiliated group (other than to a member of the electing financial institution group) in excess of the greater of—

"(I) its average annual dividend (expressed as a percentage of current earnings and profits) during the 5-taxable-year period ending with the taxable year preceding the taxable year, or

"(II) 25 percent of its average annual earnings and profits for such 5-taxable-year period, or

"(ii) deals with any person in any manner not clearly reflecting the income of the corporation (as determined under principles similar to the principles of section 482),

an amount of indebtedness of the electing financial institution group equal to the excess distribution or the understatement or overstatement of income, as the case may be, shall be recharacterized (for the taxable year and subsequent taxable years) for purposes of this paragraph as indebtedness of the worldwide affiliated group (excluding the electing financial institution group). If a corporation has not been in existence for 5 taxable years, this subparagraph shall be applied with respect to the period it was in existence.

"(D) ELECTION.—An election under this paragraph with respect to any financial institution group may be made only by the common parent of the pre-election worldwide affiliated group and may be made only for the first taxable year beginning after December 31, 2008, in which such affiliated group includes 1 or more financial corporations. Such an election, once made, shall apply to all financial corporations which are members of the electing financial institution group for such taxable year and all subsequent years unless revoked with the consent of the Secretary.

"(E) DEFINITIONS RELATING TO GROUPS.—For purposes of this paragraph—

"(i) PRE-ELECTION WORLDWIDE AFFILIATED GROUP.—The term 'pre-election worldwide affiliated group' means, with respect to a corporation, the worldwide affiliated group of which such corporation would (but for an election under this paragraph) be a member for purposes of applying paragraph (1).

"(ii) ELECTING FINANCIAL INSTITUTION GROUP.—The term 'electing financial institution group' means the group of corporations to which this subsection applies separately by reason of the application of paragraph (4)(A) and which includes financial corporations by reason of an election under subparagraph (A).

"(F) REGULATIONS.—The Secretary shall prescribe such regulations as may be appropriate to carry out this subsection, including regulations—

"(i) providing for the direct allocation of interest expense in other circumstances where such allocation would be appropriate to carry out the purposes of this subsection,

"(ii) preventing assets or interest expense from being taken into account more than once, and

"(iii) dealing with changes in members of any group (through acquisitions or otherwise) treated under this paragraph as an affiliated group for purposes of this subsection.

"(6) ELECTION.—An election to have this subsection apply with respect to any worldwide affiliated group may be made only by the common parent of the domestic affiliated group referred to in paragraph (1)(C) and may be made only for the first taxable year beginning after December 31, 2008, in which a worldwide affiliated group exists which includes such affiliated group and at least one foreign corporation. Such an election, once made, shall apply to such common parent and all other corporations which are members of such worldwide affiliated group for such taxable year and all subsequent years unless revoked with the consent of the Secretary.".

(b) EXPANSION OF REGULATORY AUTHORITY.—Paragraph (7) of section 864(e) is amended—

(1) by inserting before the comma at the end of subparagraph (B) "and in other circumstances where such allocation would be appropriate to carry out the purposes of this subsection", and

(2) by striking "and" at the end of subparagraph (E), by redesignating subparagraph (F) as subparagraph (G), and by inserting after subparagraph (E) the following new subparagraph:

"(F) preventing assets or interest expense from being taken into account more than once, and".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2008.

SEC. 1082. RECHARACTERIZATION OF OVERALL DOMESTIC LOSS.

(a) GENERAL RULE.—Section 904 is amended by redesignating subsections (g), (h), (i), (j), and (k) as subsections (h), (i), (j), (k), and (l) respectively, and by inserting after subsection (f) the following new subsection:

"(g) RECHARACTERIZATION OF OVERALL DOMESTIC LOSS.—

"(1) GENERAL RULE.—For purposes of this subpart and section 936, in the case of any taxpayer who sustains an overall domestic loss for any taxable year beginning after December 31, 2005, that portion of the taxpayer's taxable income from sources within the United States for each succeeding taxable year which is equal to the lesser of—

"(A) the amount of such loss (to the extent not used under this paragraph in prior taxable years), or

"(B) 50 percent of the taxpayer's taxable income from sources within the United States for such succeeding taxable year,

shall be treated as income from sources without the United States (and not as income from sources within the United States).

"(2) OVERALL DOMESTIC LOSS DEFINED.—For purposes of this subsection—

"(A) IN GENERAL.—The term 'overall domestic loss' means any domestic loss to the extent such loss offsets taxable income from sources without the United States for the taxable year or for any preceding taxable year by reason of a carryback. For purposes of the preceding sentence, the term 'domestic loss' means the amount by which the gross income for the taxable year from sources within the United States is exceeded by the sum of the deductions properly apportioned or allocated thereto (determined without regard to any carryback from a subsequent taxable year).

"(B) TAXPAYER MUST HAVE ELECTED FOREIGN TAX CREDIT FOR YEAR OF LOSS.—The term 'overall domestic loss' shall not include any loss for any taxable year unless the taxpayer chose the benefits of this subpart for such taxable year.

"(3) CHARACTERIZATION OF SUBSEQUENT INCOME.—

"(A) IN GENERAL.—Any income from sources within the United States that is treated as income from sources without the United States under paragraph (1) shall be allocated among and increase the income categories in proportion to the loss from sources within the United States previously allocated to those income categories.

"(B) INCOME CATEGORY.—For purposes of this paragraph, the term 'income category' has the meaning given such term by subsection (f)(5)(E)(i).

"(4) COORDINATION WITH SUBSECTION (f).—The Secretary shall prescribe such regulations as may be necessary to coordinate the provisions of this subsection with the provisions of subsection (f)."

(b) CONFORMING AMENDMENTS.—

(1) Section 535(d)(2) is amended by striking "section 904(g)(6)" and inserting "section 904(h)(6)".

(2) Subparagraph (A) of section 936(a)(2) is amended by striking "section 904(f)" and inserting "subsections (f) and (g) of section 904".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to losses sustained for taxable years beginning after December 31, 2005.

SEC. 1083. REDUCTION TO 2 FOREIGN TAX CREDIT BASKETS.

(a) IN GENERAL.—Paragraph (1) of section 904(d) (relating to separate application of section with respect to certain categories of income) is amended to read as follows:

"(1) IN GENERAL.—The provisions of subsections (a), (b), and (c) and sections 902, 907, and 960 shall be applied separately with respect to—

"(A) passive category income, and

"(B) general category income."

(b) CATEGORIES.—Paragraph (2) of section 904(d) is amended by striking subparagraph (B), by redesignating subparagraph (A) as subparagraph (B), and by inserting before subparagraph (B) (as so redesignated) the following new subparagraph:

"(A) CATEGORIES.—

"(i) PASSIVE CATEGORY INCOME.—The term 'passive category income' means passive income and specified passive category income.

"(ii) GENERAL CATEGORY INCOME.—The term 'general category income' means income other than passive category income."

(c) SPECIFIED PASSIVE CATEGORY INCOME.—Subparagraph (B) of section 904(d)(2), as so redesignated, is amended by adding at the end the following new clause:

"(v) SPECIFIED PASSIVE CATEGORY INCOME.—The term 'specified passive category income' means—

"(I) dividends from a DISC or former DISC (as defined in section 992(a)) to the extent such dividends are treated as income from sources without the United States,

"(II) taxable income attributable to foreign trade income (within the meaning of section 923(b)), and

"(III) distributions from a FSC (or a former FSC) out of earnings and profits attributable to foreign trade income (within the meaning of section 923(b)) or interest or carrying charges (as defined in section 927(d)(1)) derived from a transaction which results in foreign trade income (as defined in section 923(b))."

(d) TREATMENT OF FINANCIAL SERVICES.—Paragraph (2) of section 904(d) is amended by striking subparagraph (D), by redesignating subparagraph (C) as subparagraph (D), and by inserting before subparagraph (D) (as so redesignated) the following new subparagraph:

"(C) TREATMENT OF FINANCIAL SERVICES INCOME AND COMPANIES.—

"(i) IN GENERAL.—Financial services income shall be treated as general category income in the case of—

"(I) a member of a financial services group, and

"(II) any other person if such person is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business.

"(ii) FINANCIAL SERVICES GROUP.—The term 'financial services group' means any affiliated group (as defined in section 1504(a) without regard to paragraphs (2) and (3) of section 1504(b)) which is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business. In determining whether such a group is so engaged, there shall be taken into account only the income of members of the group that are—

"(I) United States corporations, or

"(II) controlled foreign corporations in which such United States corporations own, directly or indirectly, at least 80 percent of the total voting power and value of the stock.

"(iii) PASS-THRU ENTITIES.—The Secretary shall by regulation specify for purposes of this subparagraph the treatment of financial services income received or accrued by partnerships and by other pass-thru entities which are not members of a financial services group."

(e) CONFORMING AMENDMENTS.—

(1) Clause (iii) of section 904(d)(2)(B) (relating to exceptions from passive income), as so redesignated, is amended by striking subclause (I) and by redesignating subclauses (II) and (III) as subclauses (I) and (II), respectively.

(2) Clause (i) of section 904(d)(2)(D) (defining financial services income), as so redesignated, is amended by adding "or" at the end of subclause (I) and by striking subclauses (II) and (III) and inserting the following new subclause:

"(II) passive income (determined without regard to subparagraph (B)(iii)(II))."

(3) Section 904(d)(2)(D) (defining financial services income), as so redesignated, is amended by striking clause (iii).

(4) Paragraph (3) of section 904(d) is amended to read as follows:

"(3) LOOK-THRU IN CASE OF CONTROLLED FOREIGN CORPORATIONS.—

"(A) IN GENERAL.—Except as otherwise provided in this paragraph, dividends, interest, rents, and royalties received or accrued by the taxpayer from a controlled foreign corporation in which the taxpayer is a United States shareholder shall not be treated as passive category income.

"(B) SUBPART F INCLUSIONS.—Any amount included in gross income under section 951(a)(1)(A) shall be treated as passive category income to the extent the amount so included is attributable to passive category income.

"(C) INTEREST, RENTS, AND ROYALTIES.—Any interest, rent, or royalty which is received or accrued from a controlled foreign corporation in which the taxpayer is a United States shareholder shall be treated as passive category income to the extent it is properly allocable (under regulations prescribed by the Secretary) to passive category income of the controlled foreign corporation.

"(D) DIVIDENDS.—Any dividend paid out of the earnings and profits of any controlled foreign corporation in which the taxpayer is a United States shareholder shall be treated as passive category income in proportion to the ratio of—

"(i) the portion of the earnings and profits attributable to passive category income, to

"(ii) the total amount of earnings and profits.

"(E) LOOK-THRU APPLIES ONLY WHERE SUBPART F APPLIES.—If a controlled foreign corporation meets the requirements of section 954(b)(3)(A) (relating to de minimis rule) for any taxable year, for purposes of this paragraph, none of its foreign base company income (as defined in section 954(a) without regard to section 954(b)(5)) and none of its gross insurance income (as defined in section 954(b)(3)(C)) for such taxable year shall be treated as passive category income, except that this sentence shall not apply to any income which (without regard to this sentence) would be treated as financial services income. Solely for purposes of applying subparagraph (D), passive income of a controlled foreign corporation shall not be treated as passive category income if the requirements of section 954(b)(4) are met with respect to such income.

"(F) COORDINATION WITH HIGH-TAXED INCOME PROVISIONS.—

"(i) In determining whether any income of a controlled foreign corporation is passive category income, subclause (II) of paragraph (2)(B)(iii) shall not apply.

"(ii) Any income of the taxpayer which is treated as passive category income under this paragraph shall be so treated notwithstanding any provision of paragraph (2); except that the determination of whether any amount is high-taxed income shall be made after the application of this paragraph.

"(G) DIVIDEND.—For purposes of this paragraph, the term 'dividend' includes any amount included in gross income in section 951(a)(1)(B). Any amount included in gross income under section 78 to the extent attributable to amounts included in gross income in section 951(a)(1)(A) shall not be treated as a dividend but shall be treated as included in gross income under section 951(a)(1)(A).

"(H) LOOK-THRU APPLIES TO PASSIVE FOREIGN INVESTMENT COMPANY INCLUSION.—If—

"(i) a passive foreign investment company is a controlled foreign corporation, and

"(ii) the taxpayer is a United States shareholder in such controlled foreign corporation,

any amount included in gross income under section 1293 shall be treated as income in a separate category to the extent such amount is attributable to income in such category."

(5) TREATMENT OF INCOME TAX BASE DIFFERENCES.—Paragraph (2) of section 904(d) is amended by redesignating subparagraphs (H) and (I) as subparagraphs (I) and (J), respectively, and by inserting after subparagraph (G) the following new subparagraph:

"(H) TREATMENT OF INCOME TAX BASE DIFFERENCES.—Tax imposed under the law of a foreign country or possession of the United States on an amount which does not constitute income under United States tax principles shall be treated as imposed on income described in paragraph (1)(B)."

(6) Paragraph (2) of section 904(d) is amended by adding at the end the following new subparagraph:

"(K) TRANSITIONAL RULES FOR 2005 CHANGES.—For purposes of paragraph (1)—

"(i) taxes carried from any taxable year beginning before January 1, 2005, to any taxable year beginning on or after such date, with respect to any item of income, shall be treated as described in the subparagraph of paragraph (1) in which such income would be described were such taxes paid or accrued in a taxable year beginning on or after such date, and

"(ii) the Secretary may by regulations provide for the allocation of any carryback of taxes with respect to income to such a taxable year for purposes of allocating such income among the separate categories in effect for such taxable year.".

(7) Section 904(j)(3)(A)(i) is amended by striking "subsection (d)(2)(A)" and inserting "subsection (d)(2)(B)".

(f) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2004.

SEC. 1084. LOOK-THRU RULES TO APPLY TO DIVIDENDS FROM NONCONTROLLED SECTION 902 CORPORATIONS.

(a) IN GENERAL.—Section 904(d)(4) (relating to look-thru rules apply to dividends from noncontrolled section 902 corporations) is amended to read as follows:

"(4) LOOK-THRU APPLIES TO DIVIDENDS FROM NONCONTROLLED SECTION 902 CORPORATIONS.—

"(A) IN GENERAL.—For purposes of this subsection, any dividend from a noncontrolled section 902 corporation with respect to the taxpayer shall be treated as income described in a subparagraph of paragraph (1) in proportion to the ratio of—

"(i) the portion of earnings and profits attributable to income described in such subparagraph, to

"(ii) the total amount of earnings and profits.

"(B) SPECIAL RULES.—For purposes of this paragraph—

"(i) EARNINGS AND PROFITS.—

"(I) IN GENERAL.—The rules of section 316 shall apply.

"(II) REGULATIONS.—The Secretary may prescribe regulations regarding the treatment of distributions out of earnings and profits for periods before the taxpayer's acquisition of the stock to which the distributions relate.

"(ii) INADEQUATE SUBSTANTIATION.—If the Secretary determines that the proper subparagraph of paragraph (1) in which a dividend is described has not been substantiated, such dividend shall be treated as income described in paragraph (1)(A).

"(iii) LOOK-THRU WITH RESPECT TO CARRYFORWARDS OF CREDIT.— Rules similar to subparagraph (A) also shall apply to any carryforward under subsection (c) from a taxable year beginning before January 1, 2003, of tax allocable to a dividend from a noncontrolled section 902 corporation with respect to the taxpayer. The Secretary may by regulations provide for the allocation of any carryback of tax allocable to a dividend from a noncontrolled section 902 corporation to such a taxable year for purposes of allocating such dividend among the separate categories in effect for such taxable year.

"(iv) COORDINATION WITH HIGH-TAXED INCOME PROVISIONS.—Rules similar to the rules of paragraph (3)(F) shall apply for purposes of this paragraph.".

(b) CONFORMING AMENDMENTS.—

(1) Section 904(d)(2)(E) is amended—

(A) by inserting "or (4)" after "paragraph (3)" in clause (i), and

(B) by striking clauses (ii) and (iv) and by redesignating clause (iii) as clause (ii).

(2) Clause (i) of section 864(d)(5)(A) is amended to read as follows:

"(i) Subclause (I) of section 904(d)(2)(B)(iii)."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2002.

SEC. 1085. ATTRIBUTION OF STOCK OWNERSHIP THROUGH PARTNERSHIPS TO APPLY IN DETERMINING SECTION 902 AND 960 CREDITS.

(a) IN GENERAL.—Subsection (c) of section 902 is amended by redesignating paragraph (7) as paragraph (8) and by inserting after paragraph (6) the following new paragraph:

"(7) CONSTRUCTIVE OWNERSHIP THROUGH PARTNERSHIPS.—Stock owned, directly or indirectly, by or for a partnership shall be considered as being owned proportionately by its partners. Stock considered to be owned by a person by reason of the preceding sentence shall, for purposes of applying such sentence, be treated as actually owned by such person. The Secretary may prescribe such regulations as may be necessary to carry out the purposes of this paragraph, including rules to account for special partnership allocations of dividends, credits, and other incidents of ownership of stock in determining proportionate ownership."

(b) CLARIFICATION OF COMPARABLE ATTRIBUTION UNDER SECTION 901(b)(5).—Paragraph (5) of section 901(b) is amended by striking "any individual" and inserting "any person".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxes of foreign corporations for taxable years of such corporations beginning after the date of the enactment of this Act.

SEC. 1086. CLARIFICATION OF TREATMENT OF CERTAIN TRANSFERS OF INTANGIBLE PROPERTY.

(a) IN GENERAL.—Subparagraph (C) of section 367(d)(2) is amended by adding at the end the following new sentence: "For purposes of applying section 904(d), any such amount shall be treated in the same manner as if such amount were a royalty."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to amounts treated as received pursuant to section 367(d)(2) of the Internal Revenue Code of 1986 on or after August 5, 1997.

SEC. 1087. UNITED STATES PROPERTY NOT TO INCLUDE CERTAIN ASSETS ACQUIRED BY DEALERS IN ORDINARY COURSE OF TRADE OR BUSINESS.

(a) IN GENERAL.—Section 956(c)(2) (relating to exceptions from property treated as United States property) is amended by striking "and" at the end of subparagraph (J), by striking the period at the end of subparagraph (K) and inserting "; and", and by adding at the end the following new subparagraph:

"(L) securities acquired and held by a controlled foreign corporation in the ordinary course of its business as a dealer in securities if—

"(i) the dealer accounts for the securities as securities held primarily for sale to customers in the ordinary course of business, and

"(ii) the dealer disposes of the securities (or such securities mature while held by the dealer) within a period consistent with the holding of securities for sale to customers in the ordinary course of business."

(b) CONFORMING AMENDMENT.—Section 956(c)(2) is amended by striking "and (K)" in the last sentence and inserting ", (K), and (L)".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years of foreign corporations beginning after December 31, 2004, and to taxable years of United States shareholders with or within which such taxable years of foreign corporations end.

SEC. 1088. ELECTION NOT TO USE AVERAGE EXCHANGE RATE FOR FOREIGN TAX PAID OTHER THAN IN FUNCTIONAL CURRENCY.

(a) IN GENERAL.—Paragraph (1) of section 986(a) (relating to determination of foreign taxes and foreign corporation's earnings and profits) is amended by redesignating subparagraph (D) as subparagraph (E) and by inserting after subparagraph (C) the following new subparagraph:

"(D) ELECTIVE EXCEPTION FOR TAXES PAID OTHER THAN IN FUNCTIONAL CURRENCY.—

"(i) IN GENERAL.—At the election of the taxpayer, subparagraph (A) shall not apply to any foreign income taxes the liability for which is denominated in any currency other than in the taxpayer's functional currency.

"(ii) APPLICATION TO QUALIFIED BUSINESS UNITS.—An election under this subparagraph may apply to foreign income taxes attributable to a qualified business unit in accordance with regulations prescribed by the Secretary.

"(iii) ELECTION.—Any such election shall apply to the taxable year for which made and all subsequent taxable years unless revoked with the consent of the Secretary."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years beginning after December 31, 2004.

SEC. 1089. REPEAL OF WITHHOLDING TAX ON DIVIDENDS FROM CERTAIN FOREIGN CORPORATIONS.

(a) IN GENERAL.—Paragraph (2) of section 871(i) (relating to tax not to apply to certain interest and dividends) is amended by adding at the end the following new subparagraph:

"(D) Dividends paid by a foreign corporation which are treated under section 861(a)(2)(B) as income from sources within the United States.".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to payments made after December 31, 2004.

SEC. 1090. PROVIDE EQUAL TREATMENT FOR INTEREST PAID BY FOREIGN PARTNERSHIPS AND FOREIGN CORPORATIONS.

(a) IN GENERAL.—Paragraph (1) of section 861(a) is amended by striking "and" at the end of subparagraph (A), by striking the period at the end of subparagraph (B) and inserting ", and", and by adding at the end the following new subparagraph:

"(C) in the case of a foreign partnership in which United States persons do not hold directly or indirectly 20 percent or more of either the capital or profits interests, any interest not paid by a trade or business engaged in by the partnership in the United States and not allocable to income which is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States."

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2003.

SEC. 1091. TREATMENT OF CERTAIN DIVIDENDS OF REGULATED INVESTMENT COMPANIES.

(a) TREATMENT OF CERTAIN DIVIDENDS.—

(1) NONRESIDENT ALIEN INDIVIDUALS.—Section 871 (relating to tax on nonresident alien individuals) is amended by redesignating subsection (k) as subsection (l) and by inserting after subsection (j) the following new subsection:

"(k) EXEMPTION FOR CERTAIN DIVIDENDS OF REGULATED INVESTMENT COMPANIES.—

"(1) INTEREST-RELATED DIVIDENDS.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), no tax shall be imposed under paragraph (1)(A) of subsection (a) on any interest-related dividend received from a regulated investment company.

"(B) EXCEPTIONS.—Subparagraph (A) shall not apply—

"(i) to any interest-related dividend received from a regulated investment company by a person to the extent such dividend is attributable to interest (other than interest described in subparagraph (E) (i) or (iii)) received by such company on indebtedness issued by such person or by any corporation or partnership with respect to which such person is a 10-percent shareholder,

"(ii) to any interest-related dividend with respect to stock of a regulated investment company unless the person who would otherwise be required to deduct and withhold tax from such dividend under chapter 3 receives a statement (which meets requirements similar to the requirements of subsection (h)(5)) that the beneficial owner of such stock is not a United States person, and

"(iii) to any interest-related dividend paid to any person within a foreign country (or any interest-related dividend payment addressed to, or for the account of, persons within such foreign country) during any period described in subsection (h)(6) with respect to such country.

Clause (iii) shall not apply to any dividend with respect to any stock which was acquired on or before the date of the publication of the Secretary's determination under subsection (h)(6).

"(C) INTEREST-RELATED DIVIDEND.—For purposes of this paragraph, an interest-related dividend is any dividend (or part thereof) which is designated by the regulated investment company as an interest-related dividend in a written notice mailed to its shareholders not later than 60 days after the close of its taxable year. If the aggregate amount so designated with respect to a taxable year of the company (including amounts so designated with respect to dividends paid after the close of the taxable year described in section 855) is greater than the qualified net interest income of the company for such taxable year, the portion of each distribution which shall be an interest-related dividend shall be only that portion of the amounts so designated which such qualified net interest income bears to the aggregate amount so designated.

"(D) QUALIFIED NET INTEREST INCOME.—For purposes of subparagraph (C), the term 'qualified net interest income' means the qualified interest income of the regulated investment company reduced by the deductions properly allocable to such income.

"(E) QUALIFIED INTEREST INCOME.—For purposes of subparagraph (D), the term 'qualified interest income' means the sum of the following amounts derived by the regulated investment company from sources within the United States:

"(i) Any amount includible in gross income as original issue discount (within the meaning of section 1273) on an obligation payable 183 days or less from the date of original issue (without regard to the period held by the company).

"(ii) Any interest includible in gross income (including amounts recognized as ordinary income in respect of original issue discount or market discount or acquisition discount under part V of subchapter P and such other amounts as regulations may provide) on an obligation which is in registered form; except that this clause shall not apply to—

"(I) any interest on an obligation issued by a corporation or partnership if the regulated investment company is a 10-percent shareholder in such corporation or partnership, and

"(II) any interest which is treated as not being portfolio interest under the rules of subsection (h)(4).

"(iii) Any interest referred to in subsection (i)(2)(A) (without regard to the trade or business of the regulated investment company).

"(iv) Any interest-related dividend includable in gross income with respect to stock of another regulated investment company.

"(F) 10-PERCENT SHAREHOLDER.—For purposes of this paragraph, the term '10-percent shareholder' has the meaning given such term by subsection (h)(3)(B).

"(2) SHORT-TERM CAPITAL GAIN DIVIDENDS.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), no tax shall be imposed under paragraph (1)(A) of subsection (a) on any short-term capital gain dividend received from a regulated investment company.

"(B) EXCEPTION FOR ALIENS TAXABLE UNDER SUBSECTION (a)(2).—Subparagraph (A) shall not apply in the case of any nonresident alien individual subject to tax under subsection (a)(2).

"(C) SHORT-TERM CAPITAL GAIN DIVIDEND.—For purposes of this paragraph, a short-term capital gain dividend is any dividend (or part thereof) which is designated by the regulated investment company as a short-term capital gain dividend in a written notice mailed to its shareholders not later than 60 days after the close of its taxable year. If the aggregate amount so designated with respect to a taxable year of the company (including amounts so designated with respect to dividends paid after the close of the taxable year described in section 855) is greater than the qualified short-term gain of the company for such taxable year, the portion of each distribution which shall be a short-term capital gain dividend shall be only that portion of the amounts so designated which such qualified short-term gain bears to the aggregate amount so designated.

"(D) QUALIFIED SHORT-TERM GAIN.—For purposes of subparagraph (C), the term 'qualified short-term gain' means the excess of the net short-term capital gain of the regulated investment company for the taxable year over the net long-term capital loss (if any) of such company for such taxable year. For purposes of this subparagraph—

"(i) the net short-term capital gain of the regulated investment company shall be computed by treating any short-term capital gain dividend includible in gross income with respect to stock of another regulated investment company as a short-term capital gain, and

"(ii) the excess of the net short-term capital gain for a taxable year over the net long-term capital loss for a taxable year (to which an election under section 4982(e)(4) does not apply) shall be determined without regard to any net capital loss or net short-term capital loss attributable to transactions after October 31 of such year, and any such net capital loss or net short-term capital loss shall be treated as arising on the 1st day of the next taxable year.

To the extent provided in regulations, clause (ii) shall apply also for purposes of computing the taxable income of the regulated investment company."

(2) FOREIGN CORPORATIONS.—Section 881 (relating to tax on income of foreign corporations not connected with United States business) is amended by redesignating subsection (e) as subsection (f) and by inserting after subsection (d) the following new subsection:

"(e) TAX NOT TO APPLY TO CERTAIN DIVIDENDS OF REGULATED INVESTMENT COMPANIES.—

"(1) INTEREST-RELATED DIVIDENDS.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), no tax shall be imposed under paragraph (1) of subsection (a) on any interest-related dividend (as defined in section 871(k)(1)) received from a regulated investment company.

"(B) EXCEPTION.—Subparagraph (A) shall not apply—

"(i) to any dividend referred to in section 871(k)(1)(B), and

"(ii) to any interest-related dividend received by a controlled foreign corporation (within the meaning of section 957(a)) to the extent such dividend is attributable to interest received by the regulated investment company from a person who is a related person (within the meaning of section 864(d)(4)) with respect to such controlled foreign corporation.

"(C) TREATMENT OF DIVIDENDS RECEIVED BY CONTROLLED FOREIGN CORPORATIONS.—The rules of subsection (c)(5)(A) shall apply to any interest-related dividend received by a controlled foreign corporation (within the meaning of section 957(a)) to the extent such dividend is attributable to interest received by the regulated investment company which is described in clause (ii) of section 871(k)(1)(E) (and not described in clause (i) or (iii) of such section).

"(2) SHORT-TERM CAPITAL GAIN DIVIDENDS.—No tax shall be imposed under paragraph (1) of subsection (a) on any short-term capital gain dividend (as defined in section 871(k)(2)) received from a regulated investment company."

(3) WITHHOLDING TAXES.—

(A) Section 1441(c) (relating to exceptions) is amended by adding at the end the following new paragraph:

"(12) CERTAIN DIVIDENDS RECEIVED FROM REGULATED INVESTMENT COMPANIES.—

"(A) IN GENERAL.—No tax shall be required to be deducted and withheld under subsection (a) from any amount exempt from the tax imposed by section 871(a)(1)(A) by reason of section 871(k).

"(B) SPECIAL RULE.—For purposes of subparagraph (A), clause (i) of section 871(k)(1)(B) shall not apply to any dividend unless the regulated investment company knows that such dividend is a dividend referred to in such clause. A similar rule shall apply with respect to the exception contained in section 871(k)(2)(B)."

(B) Section 1442(a) (relating to withholding of tax on foreign corporations) is amended—

(i) by striking "and the reference in section 1441(c)(10)" and inserting "the reference in section 1441(c)(10)", and

(ii) by inserting before the period at the end the following: ", and the references in section 1441(c)(12) to sections 871(a) and 871(k) shall be treated as referring to sections 881(a) and 881(e) (except that for purposes of applying subparagraph (A) of section 1441(c)(12), as so modified, clause (ii) of section 881(e)(1)(B) shall not apply to any dividend unless the regulated investment company knows that such dividend is a dividend referred to in such clause)".

(b) ESTATE TAX TREATMENT OF INTEREST IN CERTAIN REGULATED INVESTMENT COMPANIES.—Section 2105 (relating to property without the United States for estate tax purposes) is amended by adding at the end the following new subsection:

"(d) STOCK IN A RIC.—

"(1) IN GENERAL.—For purposes of this subchapter, stock in a regulated investment company (as defined in section 851) owned by a nonresident not a citizen of the United States shall not be deemed property within the United States in the proportion that, at the end of the quarter of such investment company's taxable year immediately preceding a decedent's date of death (or at such other time as the Secretary may designate in regulations), the assets of the investment company that were qualifying assets with respect to the decedent bore to the total assets of the investment company.

"(2) QUALIFYING ASSETS.—For purposes of this subsection, qualifying assets with respect to a decedent are assets that, if owned directly by the decedent, would have been—

"(A) amounts, deposits, or debt obligations described in subsection (b) of this section,

"(B) debt obligations described in the last sentence of section 2104(c), or

"(C) other property not within the United States."

(c) TREATMENT OF REGULATED INVESTMENT COMPANIES UNDER SECTION 897.—

(1) Paragraph (1) of section 897(h) is amended by striking "REIT" each place it appears and inserting "qualified investment entity".

(2) Paragraphs (2) and (3) of section 897(h) are amended to read as follows:

"(2) SALE OF STOCK IN DOMESTICALLY CONTROLLED ENTITY NOT TAXED.—The term 'United States real property interest' does not include any interest in a domestically controlled qualified investment entity.

"(3) DISTRIBUTIONS BY DOMESTICALLY CONTROLLED QUALIFIED INVESTMENT ENTITIES.—In the case of a domestically controlled qualified investment entity, rules similar to the rules of subsection (d) shall apply to the foreign ownership percentage of any gain."

(3) Subparagraphs (A) and (B) of section 897(h)(4) are amended to read as follows:

"(A) QUALIFIED INVESTMENT ENTITY.—The term 'qualified investment entity' means any real estate investment trust and any regulated investment company.

"(B) DOMESTICALLY CONTROLLED.—The term 'domestically controlled qualified investment entity' means any qualified investment entity in which at all times during the testing period less than 50 percent in value of the stock was held directly or indirectly by foreign persons."

(4) Subparagraphs (C) and (D) of section 897(h)(4) are each amended by striking "REIT" and inserting "qualified investment entity".

(5) The subsection heading for subsection (h) of section 897 is amended by striking "REITS" and inserting "CERTAIN INVESTMENT ENTITIES".

(d) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall apply to dividends with respect to taxable years of regulated investment companies beginning after the date of the enactment of this Act.

(2) ESTATE TAX TREATMENT.—The amendment made by subsection (b) shall apply to estates of decedents dying after the date of the enactment of this Act.

(3) CERTAIN OTHER PROVISIONS.—The amendments made by subsection (c) (other than paragraph (1) thereof) shall take effect on the date of the enactment of this Act.

Subtitle I—Other Provisions

SEC. 1101. SPECIAL RULES FOR LIVESTOCK SOLD ON ACCOUNT OF WEATHER-RELATED CONDITIONS.

(a) RULES FOR REPLACEMENT OF INVOLUNTARILY CONVERTED LIVESTOCK.—Subsection (e) of section 1033 (relating to involuntary conversions) is amended—

(1) by striking "CONDITIONS.—For purposes" and inserting "CONDITIONS.—

"(1) IN GENERAL.—For purposes", and

(2) by adding at the end the following new paragraph:

"(2) EXTENSION OF REPLACEMENT PERIOD.—

"(A) IN GENERAL.—In the case of drought, flood, or other weather-related conditions described in paragraph (1) which result in the area being designated as eligible for assistance by the Federal Government, subsection (a)(2)(B) shall be applied with respect to any converted property by substituting '4 years' for '2 years'.

"(B) FURTHER EXTENSION BY SECRETARY.—The Secretary may extend on a regional basis the period for replacement under this section (after the application of subparagraph (A)) for such additional time as the Secretary determines appropriate if the weather-related conditions which resulted in such application continue for more than 3 years.".

(b) INCOME INCLUSION RULES.—Subsection (e) of section 451 (relating to special rule for proceeds from livestock sold on account of drought, flood, or other weather-related conditions) is amended by adding at the end the following new paragraph:

"(3) SPECIAL ELECTION RULES.—If section 1033(e)(2) applies to a sale or exchange of livestock described in paragraph (1), the election under paragraph (1) shall be deemed valid if made during the replacement period described in such section.".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to any taxable year with respect to which the due date (without regard to extensions) for the return is after December 31, 2002.

SEC. 1102. PAYMENT OF DIVIDENDS ON STOCK OF COOPERATIVES WITHOUT REDUCING PATRONAGE DIVIDENDS.

(a) IN GENERAL.—Subsection (a) of section 1388 (relating to patronage dividend defined) is amended by adding at the end the following: "For purposes of paragraph (3), net earnings shall not be reduced by amounts paid during the year as dividends on capital stock or other proprietary capital interests of the organization to the extent that the articles of incorporation or bylaws of such organization or other contract with patrons provide that such dividends are in addition to amounts otherwise payable to patrons which are derived from business done with or for patrons during the taxable year.".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to distributions in taxable years beginning after the date of the enactment of this Act.

SEC. 1103. VACCINE TAX TO APPLY TO HEPATITIS A VACCINE.

(a) IN GENERAL.—Paragraph (1) of section 4132(a) (defining taxable vaccine) is amended by redesignating subparagraphs (I), (J), (K), and (L) as subparagraphs (J), (K), (L), and (M), respectively, and by inserting after subparagraph (H) the following new subparagraph:

"(I) Any vaccine against hepatitis A."

(b) EFFECTIVE DATE.—

(1) SALES, ETC.—The amendments made by subsection (a) shall apply to sales and uses on or after the first day of the first month which begins more than 4 weeks after the date of the enactment of this Act.

(2) DELIVERIES.—For purposes of paragraph (1) and section 4131 of the Internal Revenue Code of 1986, in the case of sales on or before the effective date described in such paragraph for which delivery is made after such date, the delivery date shall be considered the sale date.

SEC. 1104. EXPANSION OF HUMAN CLINICAL TRIALS QUALIFYING FOR ORPHAN DRUG CREDIT.

(a) IN GENERAL.—Paragraph (2) of section 45C(b) (relating to qualified clinical testing expenses) is amended by adding at the end the following new subparagraph:

"(C) TREATMENT OF CERTAIN EXPENSES INCURRED BEFORE DESIGNATION.— For purposes of subparagraph (A)(ii)(I), if a drug is designated under section 526 of the Federal Food, Drug, and Cosmetic Act not later than the due date (including extensions) for filing the return of tax under this subtitle for the taxable year in which the application for such designation of such drug was filed, such drug shall be treated as having been designated on the date that such application was filed.".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to expenses incurred after the date of the enactment of this Act.

SEC. 1105. DISTRIBUTIONS FROM PUBLICLY TRADED PARTNERSHIPS TREATED AS QUALIFYING INCOME OF REGULATED INVESTMENT COMPANIES.

(a) IN GENERAL.—Paragraph (2) of section 851(b) (defining regulated investment company) is amended to read as follows:

"(2) at least 90 percent of its gross income is derived from—

"(A) dividends, interest, payments with respect to securities loans (as defined in section 512(a)(5)), and gains from the sale or other disposition of stock or securities (as defined in section 2(a)(36) of the Investment Company Act of 1940, as amended) or foreign currencies, or other income (including but not limited to gains from options, futures or forward contracts) derived with respect to its business of investing in such stock, securities, or currencies, and

"(B) distributions or other income derived from an interest in a qualified publicly traded partnership (as defined in subsection (h)); and".

(b) SOURCE FLOW-THROUGH RULE NOT TO APPLY.—The last sentence of section 851(b) is amended by inserting "(other than a qualified publicly traded partnership as defined in subsection (h))" after "derived from a partnership".

(c) LIMITATION ON OWNERSHIP.—Subsection (c) of section 851 is amended by redesignating paragraph (5) as paragraph (6) and inserting after paragraph (4) the following new paragraph:

"(5) The term 'outstanding voting securities of such issuer' shall include the equity securities of a qualified publicly traded partnership (as defined in subsection (h)).".

(d) DEFINITION OF QUALIFIED PUBLICLY TRADED PARTNERSHIP.—Section 851 is amended by adding at the end the following new subsection:

"(h) QUALIFIED PUBLICLY TRADED PARTNERSHIP.—For purposes of this section, the term 'qualified publicly traded partnership' means a publicly traded partnership described in section 7704(b) other than a partnership which would satisfy the gross income requirements of section 7704(c)(2) if qualifying income included only income described in subsection (b)(2)(A).".

(e) DEFINITION OF QUALIFYING INCOME.—Section 7704(d)(4) is amended by striking "section 851(b)(2)" and inserting "section 851(b)(2)(A)".

(f) LIMITATION ON COMPOSITION OF ASSETS.—Subparagraph (B) of section 851(b)(3) is amended to read as follows:

"(B) not more than 25 percent of the value of its total assets is invested in—

"(i) the securities (other than Government securities or the securities of other regulated investment companies) of any one issuer, "(ii) the securities (other than the securities of other regulated investment companies) of two or more issuers which the taxpayer controls and which are determined, under regulations prescribed by the Secretary, to be engaged in the same or similar trades or businesses or related trades or businesses, or

"(iii) the securities of one or more qualified publicly traded partnerships (as defined in subsection (h)).".

(g) APPLICATION OF SPECIAL PASSIVE ACTIVITY RULE TO REGULATED INVESTMENT COMPANIES.—Subsection (k) of section 469 (relating to separate application of section in case of publicly traded partnerships) is amended by adding at the end the following new paragraph:

"(4) APPLICATION TO REGULATED INVESTMENT COMPANIES.—For purposes of this section, a regulated investment company (as defined in section 851) holding an interest in a qualified publicly traded partnership (as defined in section 851(h)) shall be treated as a taxpayer described in subsection (a)(2) with respect to items attributable to such interest.".

(h) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

SEC. 1106. IMPROVEMENTS RELATED TO REAL ESTATE INVESTMENT TRUSTS.

(a) EXPANSION OF STRAIGHT DEBT SAFE HARBOR.—Section 856 (defining real estate investment trust) is amended—

(1) in subsection (c) by striking paragraph (7), and

(2) by adding at the end the following new subsection:

"(m) SAFE HARBOR IN APPLYING SUBSECTION (c)(4).—

"(1) IN GENERAL.—In applying subclause (III) of subsection (c)(4)(B)(iii), except as otherwise determined by the Secretary in regulations, the following shall not be considered securities held by the trust:

"(A) Straight debt securities of an issuer which meet the requirements of paragraph (2).

"(B) Any loan to an individual or an estate.

"(C) Any section 467 rental agreement (as defined in section 467(d)), other than with a person described in subsection (d)(2)(B).

"(D) Any obligation to pay rents from real property (as defined in subsection (d)(1)).

"(E) 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 subparagraph or payments on any obligation issued by such an entity,

"(F) Any security issued by a real estate investment trust.

"(G) Any other arrangement as determined by the Secretary.

"(2) SPECIAL RULES RELATING TO STRAIGHT DEBT SECURITIES.—

"(A) IN GENERAL.—For purposes of paragraph (1)(A), securities meet the requirements of this paragraph if such securities are straight debt, as defined in section 1361(c)(5) (without regard to subparagraph (B)(iii) thereof).

"(B) SPECIAL RULES RELATING TO CERTAIN CONTINGENCIES.—For purposes of subparagraph (A), 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—

"(i) any such contingency 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, or

"(ii) neither the aggregate issue price nor the aggregate face amount of the issuer's debt instruments held by the trust exceeds $1,000,000 and not more than 12 months of unaccrued interest can be required to be prepaid thereunder.

"(C) SPECIAL RULES RELATING TO CORPORATE OR PARTNERSHIP ISSUERS.—In the case of an issuer which is a corporation or a partnership, securities that otherwise would be described in paragraph (1)(A) shall be considered not to be so described if the trust holding such securities and any of its controlled taxable REIT subsidiaries (as defined in subsection (d)(8)(A)(iv)) hold any securities of the issuer which—

"(i) are not described in paragraph (1) (prior to the application of this subparagraph), and

"(ii) have an aggregate value greater than 1 percent of the issuer's outstanding securities determined without regard to paragraph (3)(A)(i).

"(3) LOOK-THROUGH RULE FOR PARTNERSHIP SECURITIES.—

"(A) IN GENERAL.—For purposes of applying subclause (III) of subsection (c)(4)(B)(iii)—

"(i) a trust's interest as a partner in a partnership (as defined in section 7701(a)(2)) shall not be considered a security, and

"(ii) the trust shall be deemed to own its proportionate share of each of the assets of the partnership.

"(B) DETERMINATION OF TRUST'S INTEREST IN PARTNERSHIP ASSETS.—For purposes of subparagraph (A), with respect to any taxable year beginning after the date of the enactment of this subparagraph—

"(i) the trust's interest in the partnership assets shall be the trust's proportionate interest in any securities issued by the partnership (determined without regard to subparagraph (A)(i) and paragraph (4), but not including securities described in paragraph (1)), and

"(ii) the value of any debt instrument shall be the adjusted issue price thereof, as defined in section 1272(a)(4).

"(4) CERTAIN PARTNERSHIP DEBT INSTRUMENTS NOT TREATED AS A SECURITY.— For purposes of applying subclause (III) of subsection (c)(4)(B)(iii)—

"(A) any debt instrument issued by a partnership and not described in paragraph (1) shall not be considered a security to the extent of the trust's interest as a partner in the partnership, and

"(B) any debt instrument issued by a partnership and not described in paragraph (1) shall not be considered a security if at least 75 percent of the partnership's gross income (excluding gross income from prohibited transactions) is derived from sources referred to in subsection (c)(3).

"(5) SECRETARIAL GUIDANCE.—The Secretary is authorized to provide guidance (including through the issuance of a written determination, as defined in section 6110(b)) that an arrangement shall not be considered a security held by the trust for purposes of applying subclause (III) of subsection (c)(4)(B)(iii) notwithstanding that such arrangement otherwise could be considered a security under subparagraph (F) of subsection (c)(5).".

(b) CLARIFICATION OF APPLICATION OF LIMITED RENTAL EXCEPTION.—Subparagraph (A) of section 856(d)(8) (relating to special rules for taxable REIT subsidiaries) is amended to read as follows:

"(A) LIMITED RENTAL EXCEPTION.—

"(i) IN GENERAL.—The requirements of this subparagraph are met with respect to any property if at least 90 percent of the leased space of the property is rented to persons other than taxable REIT subsidiaries of such trust and other than persons described in paragraph (2)(B).

"(ii) RENTS MUST BE SUBSTANTIALLY COMPARABLE.—Clause (i) shall apply only to the extent that the amounts paid to the trust as rents from real property (as defined in paragraph (1) without regard to paragraph (2)(B)) from such property are substantially comparable to such rents paid by the other tenants of the trust's property for comparable space.

"(iii) TIMES FOR TESTING RENT COMPARABILITY.—The substantial comparability requirement of clause (ii) shall be treated as met with respect to a lease to a taxable REIT subsidiary of the trust if such requirement is met under the terms of the lease—

"(I) at the time such lease is entered into,

"(II) at the time of each extension of the lease, including a failure to exercise a right to terminate, and

"(III) at the time of any modification of the lease between the trust and the taxable REIT subsidiary if the rent under such lease is effectively increased pursuant to such modification.

With respect to subclause (III), if the taxable REIT subsidiary of the trust is a controlled taxable REIT subsidiary of the trust, the term 'rents from real property' shall not in any event include rent under such lease to the extent of the increase in such rent on account of such modification.

"(iv) CONTROLLED TAXABLE REIT SUBSIDIARY.—For purposes of clause (iii), the term 'controlled taxable REIT subsidiary' means, with respect to any real estate investment trust, any taxable REIT subsidiary of such trust if such trust owns directly or indirectly—

"(I) stock possessing more than 50 percent of the total voting power of the outstanding stock of such subsidiary, or

"(II) stock having a value of more than 50 percent of the total value of the outstanding stock of such subsidiary.

"(v) CONTINUING QUALIFICATION BASED ON THIRD PARTY ACTIONS.—If the requirements of clause (i) are met at a time referred to in clause (iii), such requirements shall continue to be treated as met so long as there is no increase in the space leased to any taxable REIT subsidiary of such trust or to any person described in paragraph (2)(B).

"(vi) CORRECTION PERIOD.—If there is an increase referred to in clause (v) during any calendar quarter with respect to any property, the requirements of clause (iii) shall be treated as met during the quarter and the succeeding quarter if such requirements are met at the close of such succeeding quarter.".

(c) DELETION OF CUSTOMARY SERVICES EXCEPTION.—Subparagraph (B) of section 857(b)(7) (relating to redetermined rents) is amended by striking clause (ii) and by redesignating clauses (iii), (iv), (v), (vi), and (vii) as clauses (ii), (iii), (iv), (v), and (vi), respectively.

(d) CONFORMITY WITH GENERAL HEDGING DEFINITION.—Subparagraph (G) of section 856(c)(5) (relating to treatment of certain hedging instruments) is amended to read as follows:

"(G) TREATMENT OF CERTAIN HEDGING INSTRUMENTS.—Except to the extent provided by regulations, any income of a real estate investment trust from a hedging transaction (as defined in clause (ii) or (iii) of section 1221(b)(2)(A)) which is clearly identified pursuant to section 1221(a)(7), including gain from the sale or disposition of such a transaction, shall not constitute gross income under paragraph (2) to the extent that the transaction hedges any indebtedness incurred or to be incurred by the trust to acquire or carry real estate assets.".

(e) CONFORMITY WITH REGULATED INVESTMENT COMPANY RULES.—Clause (i) of section 857(b)(5)(A) (relating to imposition of tax in case of failure to meet certain requirements) is amended by striking "90 percent" and inserting "95 percent".

(f) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to taxable years beginning after December 31, 2000.

(2) SUBPARAGRAPHS (c) THROUGH (e).—The amendments made by subsections (c), (d), and (e) shall apply to taxable years beginning after the date of the enactment of this Act.

SEC. 1107. SIMPLIFICATION OF EXCISE TAX IMPOSED ON BOWS AND ARROWS.

(a) BOWS.—Paragraph (1) of section 4161(b) (relating to bows) is amended to read as follows:

"(1) BOWS.—

"(A) IN GENERAL.—There is hereby imposed on the sale by the manufacturer, producer, or importer of any bow which has a peak draw weight of 30 pounds or more, a tax equal to 11 percent of the price for which so sold.

"(B) ARCHERY EQUIPMENT.—There is hereby imposed on the sale by the manufacturer, producer, or importer—

"(i) of any part or accessory suitable for inclusion in or attachment to a bow described in subparagraph (A), and

"(ii) of any quiver or broadhead suitable for use with an arrow described in paragraph (3),

a tax equal to 11 percent of the price for which so sold.".

(b) ARROWS.—Subsection (b) of section 4161 (relating to bows and arrows, etc.) is amended by redesignating paragraph (3) as paragraph (4) and inserting after paragraph (2) the following:

"(3) ARROWS.—

"(A) IN GENERAL.—There is hereby imposed on the sale by the manufacturer, producer, or importer of any arrow, a tax equal to 12 percent of the price for which so sold.

"(B) EXCEPTION.—The tax imposed by subparagraph (A) on an arrow shall not apply if the arrow contains an arrow shaft with respect to which tax was paid under paragraph (2).

"(C) ARROW.—For purposes of this paragraph, the term 'arrow' means any shaft described in paragraph (2) to which additional components are attached.".

(c) CONFORMING AMENDMENTS.—(1) Section 4161(b)(2) is amended by inserting "(other than a broadhead)" after "point".

(2) The heading of section 4161(b)(2) is amended by striking "ARROWS.—" and inserting "ARROW COMPONENTS.—".

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to articles sold by the manufacturer, producer, or importer after December 31, 2003.

SEC. 1108. REPEAL OF EXCISE TAX ON FISHING TACKLE BOXES.

(a) REPEAL.—Paragraph (6) of section 4162(a) (defining sport fishing equipment) is amended by striking subparagraph (C) and by redesignating subparagraphs (D) through (J) as subparagraphs (C) through (I), respectively.

(b) EFFECTIVE DATE.—The amendments made this section shall apply to articles sold by the manufacturer, producer, or importer after December 31, 2003.

SEC. 1109. INCOME TAX CREDIT TO DISTILLED SPIRITS WHOLESALERS FOR COST OF CARRYING FEDERAL EXCISE TAXES ON BOTTLED DISTILLED SPIRITS.

(a) IN GENERAL.—Subpart A of part I of subchapter A of chapter 51 (relating to gallonage and occupational taxes) is amended by adding at the end the following new section:

"SEC. 5011. INCOME TAX CREDIT FOR WHOLESALER'S AVERAGE COST OF CARRYING EXCISE TAX.

"(a) IN GENERAL.—For purposes of section 38, in the case of an eligible wholesaler, the amount of the distilled spirits wholesalers credit for any taxable year is the amount equal to the product of—

"(1) the number of cases of bottled distilled spirits—

"(A) which were bottled in the United States, and

"(B) which are purchased by such wholesaler during the taxable year directly from the bottler of such spirits, and

"(2) the average tax-financing cost per case for the most recent calendar year ending before the beginning of such taxable year.

"(b) ELIGIBLE WHOLESALER.—For purposes of this section, the term 'eligible wholesaler' means any person who holds a permit under the Federal Alcohol Administration Act as a wholesaler of distilled spirits.

"(c) AVERAGE TAX-FINANCING COST.—

"(1) IN GENERAL.—For purposes of this section, the average tax-financing cost per case for any calendar year is the amount of interest which would accrue at the deemed financing rate during a 60-day period on an amount equal to the deemed Federal excise per case.

"(2) DEEMED FINANCING RATE.—For purposes of paragraph (1), the deemed financing rate for any calendar year is the average of the corporate overpayment rates under paragraph (1) of section 6621(a) (determined without regard to the last sentence of such paragraph) for calendar quarters of such year.

"(3) DEEMED FEDERAL EXCISE TAX BASED ON CASE OF 12 80-PROOF 750ML BOTTLES.—For purposes of paragraph (1), the deemed Federal excise tax per case is $22.83.

"(4) NUMBER OF CASES IN LOT.—For purposes of this section, the number of cases in any lot of distilled spirits shall be determined by dividing the number of liters in such lot by 9."

(b) CONFORMING AMENDMENTS.—

(1) Subsection (b) of section 38 is amended by striking "plus" at the end of paragraph (14), by striking the period at the end of paragraph (15) and inserting ", plus", and by adding at the end the following new paragraph:

"(16) in the case of an eligible wholesaler (as defined in section 5011(b)), the distilled spirits wholesaler credit determined under section 5011(a)."

(2) Subsection (d) of section 39 (relating to carryback and carryforward of unused credits) is amended by adding at the end the following new paragraph:

"(11) NO CARRYBACK OF SECTION 5011 CREDIT BEFORE JANUARY 1, 2004.—No portion of the unused business credit for any taxable year which is attributable to the credit determined under section 5011(a) may be carried back to a taxable year beginning before January 1, 2004.".

(3) The table of sections for subpart A of part I of subchapter A of chapter 51 is amended by adding at the end the following new item:

"Sec. 5011. Income tax credit for wholesaler's average cost of carrying excise tax.".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2003.

SEC. 1110. CAPITAL GAIN TREATMENT UNDER SECTION 631(b) TO APPLY TO OUTRIGHT SALES BY LANDOWNERS.

(a) IN GENERAL.—The first sentence of section 631(b) (relating to disposal of timber with a retained economic interest) is amended by striking "retains an economic interest in such timber" and inserting "either retains an economic interest in such timber or makes an outright sale of such timber".

(b) CONFORMING AMENDMENTS.—

(1) The third sentence of section 631(b) is amended by striking "The date of disposal" and inserting "In the case of disposal of timber with a retained economic interest, the date of disposal".

(2) The heading for section 631(b) is amended by striking "WITH A RETAINED ECONOMIC INTEREST".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to sales after December 31, 2003.

SEC. 1111. SONAR DEVICES SUITABLE FOR FINDING FISH.

(a) NOT TREATED AS SPORT FISHING EQUIPMENT.—Subsection (a) of section 4162 (relating to sport fishing equipment defined) is amended by inserting "and" at the end of paragraph (8), by striking ", and" at the end of paragraph (9) and inserting a period, and by striking paragraph (10).

(b) CONFORMING AMENDMENT.—Section 4162 is amended by striking subsection (b) and by redesignating subsection (c) as subsection (b).

(c) EFFECTIVE DATE.—The amendments made this section shall apply to articles sold by the manufacturer, producer, or importer after December 31, 2003.

SEC. 1112. TAXATION OF CERTAIN SETTLEMENT FUNDS.

(a) IN GENERAL.—Subsection (g) of section 468B (relating to clarification of taxation of certain funds) is amended to read as follows:

"(g) CLARIFICATION OF TAXATION OF CERTAIN FUNDS.—

"(1) IN GENERAL.—Except as provided in paragraph (2), nothing in any provision of law shall be construed as providing that an escrow account, settlement fund, or similar fund is not subject to current income tax. The Secretary shall prescribe regulations providing for the taxation of any such account or fund whether as a grantor trust or otherwise.

"(2) EXEMPTION FROM TAX FOR CERTAIN SETTLEMENT FUNDS.—An escrow account, settlement fund, or similar fund shall be treated as beneficially owned by the United States and shall be exempt from taxation under this subtitle if—

"(A) it is established pursuant to a consent decree entered by a judge of a United States District Court,

"(B) it is created for the receipt of settlement payments as directed by a government entity for the sole purpose of resolving or satisfying one or more claims asserting liability under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980,

"(C) the authority and control over the expenditure of funds therein (including the expenditure of contributions thereto and any net earnings thereon) is with such government entity, and

"(D) upon termination, any remaining funds will be disbursed upon instructions by such government entity in accordance with applicable law.

For purposes of this paragraph, the term 'government entity' means the United States, any State or political subdivision thereof, the District of Columbia, any possession of the United States, and any agency or instrumentality of any of the foregoing.".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years beginning after December 31, 2003.

SEC. 1113. SUSPENSION OF OCCUPATIONAL TAXES RELATING TO DISTILLED SPIRITS, WINE, AND BEER.

(a) IN GENERAL.—Subpart G of part II of subchapter A of chapter 51 is amended by redesignating section 5148 as section 5149 and by inserting after section 5147 the following new section:

"SEC. 5148. SUSPENSION OF OCCUPATIONAL TAX.

"(a) IN GENERAL.—Notwithstanding sections 5081, 5091, 5111, 5121, and 5131, the rate of tax imposed under such sections for the suspension period shall be zero. During such period, persons engaged in or carrying on a trade or business covered by such sections shall register under section 5141 and shall comply with the recordkeeping requirements under this part.

"(b) SUSPENSION PERIOD.—For purposes of subsection (a), the suspension period is the period beginning on July 1, 2004, and ending on June 30, 2007.".

(b) CONFORMING AMENDMENT.—Section 5117 is amended by adding at the end the following new subsection:

"(d) SPECIAL RULE DURING SUSPENSION PERIOD.—Except as provided by the Secretary, during the suspension period (as defined in section 5148) it shall be unlawful for any dealer to purchase distilled spirits for resale from any person other than a wholesale dealer in liquors who is required to keep records under section 5114.".

(c) CLERICAL AMENDMENT.—The table of sections for subpart G of part II of subchapter A of chapter 51 is amended by striking the last item and inserting the following new items:

"Sec. 5148. Suspension of occupational tax.
"Sec. 5149. Cross references.".

(d) EFFECTIVE DATE.—The amendments made by this section shall take effect on the date of the enactment of this Act.

TITLE II—PROVISIONS TO REDUCE TAX AVOIDANCE THROUGH CORPORATE EARNINGS STRIPPING AND EXPATRIATION

SEC. 2001. REDUCTION IN POTENTIAL FOR EARNINGS STRIPPING BY FURTHER LIMITING DEDUCTION FOR INTEREST ON CERTAIN INDEBTEDNESS.

(a) REDUCTION IN POTENTIAL FOR EARNINGS STRIPPING.—

(1) IN GENERAL.—Section 163(j) is amended by striking paragraphs (1) and (2), by redesignating paragraphs (3) through (8) as paragraphs (4) through (9), respectively, and by inserting before paragraph (4), as so redesignated, the following new paragraphs:

"(1) LIMITATION.—

"(A) IN GENERAL.—In the case of a corporation, no deduction shall be allowed under this chapter for disqualified interest paid or accrued during the taxable year.

"(B) MAXIMUM DISALLOWANCE.—The amount disallowed under subparagraph (A) shall not exceed the sum of—

"(i) the corporation's excess interest expense for the taxable year, and

"(ii) the corporation's excess related party interest expense for such year.

In no event shall the disallowance under subparagraph (A) reduce the deduction for interest below the sum of the amount of interest includible in the gross income of the taxpayer for such taxable year and an amount equal to 25 percent of adjusted taxable income (35 percent in the case of the first taxable year beginning after December 31, 2003).

"(C) DISALLOWED AMOUNT CARRIED TO SUCCEEDING TAXABLE YEAR.—

"(i) IN GENERAL.—Any amount disallowed under subparagraph (A) for any taxable year shall be treated as paid or accrued in the succeeding taxable year and in the 2nd through 10th succeeding taxable years to the extent not previously taken into account under this subparagraph.

"(ii) LIMITATION ON AMOUNT CARRIED TO YEAR.—A carryforward amount may not be taken into account for any such succeeding taxable year to the extent that such amount, when added to amounts carried to such succeeding taxable year from taxable years preceding the taxable year from which the amount is being carried forward, would result in (or increase) a disallowance under subparagraph (A).

"(iii) CARRYOVER APPLIED SEPARATELY TO CATEGORIES OF DISQUALIFIED INTEREST.—Clauses (i) and (ii) shall be applied separately to disqualified interest described in paragraph (3)(A) and to disqualified interest described in paragraph (3)(B). For purposes of this subparagraph, any amount disallowed under subparagraph (A) for any taxable year shall be treated as disqualified interest described in paragraph (3)(A) to the extent thereof and then as disqualified interest described in paragraph (3)(B).

"(2) EXCESS INTEREST EXPENSE; EXCESS RELATED PARTY INTEREST EXPENSE.—For purposes of this subsection—

"(A) EXCESS INTEREST EXPENSE.—The term 'excess interest expense' means the excess (if any) of—

"(i) the corporation's net interest expense, over

"(ii) 50 percent of the adjusted taxable income of the corporation.

"(B) EXCESS RELATED PARTY INTEREST EXPENSE.—The term 'excess related party interest expense' means the excess (if any) of—

"(i) the lesser of—

"(I) the amount of disqualified interest described in paragraph (3)(A), or

"(II) the corporation's net interest expense, over

"(ii) 25 percent (35 percent in the case of the first taxable year beginning after December 31, 2003) of the adjusted taxable income of the corporation.

"(3) ALTERNATIVE MAXIMUM DISALLOWANCE.—

"(A) IN GENERAL.—In the case of a corporation with respect to which an election is in effect under subparagraph (B), the amount disallowed under paragraph (1)(A) shall not exceed the excess (if any) of—

"(i) the corporation's net interest expense, over

"(ii) 30 percent of the adjusted taxable income of the corporation.

"(B) ELECTION.—A corporation may make a one-time irrevocable election to have the alternative maximum disallowance described in subparagraph (A) apply for purposes of this subsection in lieu of paragraph (1)(B). An election under this subparagraph shall not apply with respect to any taxable year beginning before January 1, 2005.

"(C) LIMITATION.—Subparagraph (B) shall not apply with respect to any corporation which is—

"(i) a surrogate foreign corporation (as defined in section 7874(a)(2)(B)),

"(ii) a corporation which would be a surrogate foreign corporation (as so defined) if "December 31, 1996" were substituted for "March 4, 2003" in section 7874(a), or

"(iii) a corporation which is an expatriated entity (as defined in section 7874(a)) with respect to a corporation described in clause (i) or (ii).".

(2) CONFORMING AMENDMENT.—Paragraph (5)(B)(ii) of section 163(j), as redesignated by paragraph (1), is amended by striking "paragraph (5)(B)" and inserting "paragraph (6)(B)".

(b) MAINTENANCE OF CURRENT LAW FOR INTEREST PAID BY TAXABLE REIT SUBSIDIARIES TO REIT.—

(1) EXCEPTION FROM 163(J).—Paragraph (4) of section 163(j), as redesignated by subsection (a), is amended by inserting "and" at the end of subparagraph (A), by striking ", and" at the end of subparagraph (B) and inserting a period, and by striking subparagraph (C).

(2) DISALLOWANCE.—Section 856 is amended by adding at the end the following new subsection:

"(n) LIMITATION ON DEDUCTION FOR INTEREST ON CERTAIN INDEBTEDNESS OF TAXABLE REIT SUBSIDIARY.—

"(1) LIMITATION.—

"(A) IN GENERAL.—If this subsection applies to any taxable REIT subsidiary for any taxable year, no deduction shall be allowed under this chapter for disqualified interest paid or accrued by such subsidiary during such taxable year. The amount disallowed under the preceding sentence shall not exceed the subsidiary's excess interest expense for the taxable year.

"(B) DISALLOWED AMOUNT CARRIED TO SUCCEEDING TAXABLE YEAR.—Any amount disallowed under subparagraph (A) for any taxable year shall be treated as disqualified interest paid or accrued in the succeeding taxable year (and clause (ii) of paragraph (2)(A) shall not apply for purposes of applying this subsection to the amount so treated).

"(2) SUBSIDIARIES TO WHICH SUBSECTION APPLIES.—

"(A) IN GENERAL.—This subsection shall apply to any taxable REIT subsidiary for any taxable year if—

"(i) such subsidiary has excess interest expense for such taxable year, and

"(ii) the ratio of debt to equity of such subsidiary as of the close of such taxable year (or on any other day during the taxable year as the Secretary may by regulations prescribe) exceeds 1.5 to 1.

"(B) EXCESS INTEREST EXPENSE.—

"(i) IN GENERAL.—For purposes of this subsection, the term 'excess interest expense' means the excess (if any) of—

"(I) the taxable REIT subsidiary's net interest expense, over

"(II) the sum of 50 percent of the adjusted taxable income of the subsidiary plus any excess limitation carryforward under clause (ii).

"(ii) EXCESS LIMITATION CARRYFORWARD.—If a taxable REIT subsidiary has an excess limitation for any taxable year, the amount of such excess limitation shall be an excess limitation carryforward to the

1st succeeding taxable year and to the 2nd and 3rd succeeding taxable years to the extent not previously taken into account under this clause. The amount of such a carryforward taken into account for any such succeeding taxable year shall not exceed the excess interest expense for such succeeding taxable year (determined without regard to the carryforward from the taxable year of such excess limitation).

"(iii) EXCESS LIMITATION.—For purposes of clause (ii), the term 'excess limitation' means the excess (if any) of—

"(I) 50 percent of the adjusted taxable income of the subsidiary, over

"(II) the subsidiary's net interest expense.

"(C) RATIO OF DEBT TO EQUITY.—For purposes of this paragraph, the term 'ratio of debt to equity' means the ratio which the total indebtedness of the subsidiary bears to the sum of its money and all other assets reduced (but not below zero) by such total indebtedness. The rules of section 163(j)(6)(E) shall apply for purposes of the preceding sentence.

"(3) DISQUALIFIED INTEREST.—For purposes of this subsection, the term 'disqualified interest' means any interest paid or accrued (directly or indirectly) by a taxable REIT subsidiary of a real estate investment trust to such trust.

"(4) OTHER RULES TO APPLY.—Rules similar to the rules of paragraphs (7), (8), and (9) of section 163(j) shall apply for purposes of this subsection."

(c) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall apply to taxable years beginning after December 31, 2003.

(2) EARLIER EFFECTIVE DATE WITH RESPECT TO EXPATRIATED CORPORATIONS, ETC.—The amendments made by this section shall apply to taxable years ending after March 4, 2003, in the case of a taxpayer which is—

(A) a surrogate foreign corporation, as defined in section 7874(a)(2)(B) of the Internal Revenue Code of 1986, as added by section 2002,

(B) a corporation which would be a surrogate foreign corporation (as so defined) if "December 31, 1996" were substituted for "March 4, 2003" in such section 7874(a), or

(C) a corporation which is an expatriated entity (as defined in such section 7874(a)) with respect to a corporation described in subparagraph (A) or (B).

In applying such amendments to a taxpayer described in the preceding sentence, subparagraph (B) of section 163(j)(2) of such Code, as amended by this section, shall be applied by substituting "25 percent" for "35 percent".

(3) LIMITATION ON CARRYOVER OF DISALLOWED INTEREST.—

(A) IN GENERAL.—Except in the case of a taxpayer described in paragraph (2), for purposes of applying section 163(j)(1)(C) of the Internal Revenue Code of 1986 (as added by this section), amounts carried from a taxable year beginning before January 1, 2004, to any taxable year beginning after December 31, 2003, shall be treated as disqualified interest described in section 163(j)(3)(B) of such Code which is disallowed for the most recent taxable year beginning before January 1, 2004.

(B) EXPATRIATED CORPORATIONS.—In the case of a taxpayer described in paragraph (2), a rule similar to the rule of subparagraph (A) shall apply to amounts carried from a taxable year ending on or before March 5, 2003.

SEC. 2002. TAX TREATMENT OF EXPATRIATED ENTITIES AND THEIR FOREIGN PARENTS.

(a) IN GENERAL.—Subchapter C of chapter 80 (relating to provisions affecting more than one subtitle) is amended by adding at the end the following new section:

"SEC. 7874. RULES RELATING TO EXPATRIATED ENTITIES AND THEIR FOREIGN PARENTS.

"(a) TAX ON INVERSION GAIN OF EXPATRIATED ENTITIES.—

"(1) IN GENERAL.—The taxable income of an expatriated entity for any taxable year which includes any portion of the applicable period shall in no event be less than the inversion gain of the entity for the taxable year.

"(2) EXPATRIATED ENTITY.—For purposes of this subsection—

"(A) IN GENERAL.—The term 'expatriated entity' means—

"(i) the domestic corporation or partnership referred to in subparagraph (B)(i) with respect to which a foreign corporation is a surrogate foreign corporation, and

"(ii) any United States person who is related (within the meaning of section 267(b) or 707(b)(1)) to a domestic corporation or partnership described in clause (i).

"(B) SURROGATE FOREIGN CORPORATION.—A foreign corporation shall be treated as a surrogate foreign corporation if, pursuant to a plan (or a series of related transactions)—

"(i) the entity completes after March 4, 2003, the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation or substantially all of the properties constituting a trade or business of a domestic partnership,

"(ii) after the acquisition at least 60 percent of the stock (by vote or value) of the entity is held—

"(I) in the case of an acquisition with respect to a domestic corporation, by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation, or

"(II) in the case of an acquisition with respect to a domestic partnership, by former partners of the domestic partnership by reason of holding a capital or profits interest in the domestic partnership, and

"(iii) after the acquisition the expanded affiliated group which includes the entity does not have substantial business activities in the foreign country in which, or under the law of which, the entity is created or organized, when compared to the total business activities of such expanded affiliated group.

An entity otherwise described in clause (i) with respect to any domestic corporation or partnership trade or business shall be treated as not so described if, on or before March 4, 2003, such entity acquired directly or indirectly more than half of the properties held directly or indirectly by such corporation or more than half of the properties constituting such partnership trade or business, as the case may be.

"(b) DEFINITIONS AND SPECIAL RULES.—

"(1) EXPANDED AFFILIATED GROUP.—The term 'expanded affiliated group' means an affiliated group as defined in section 1504(a) but without regard to section 1504(b)(3), except that section 1504(a) shall be applied by substituting 'more than 50 percent' for 'at least 80 percent' each place it appears.

"(2) CERTAIN STOCK DISREGARDED.—There shall not be taken into account in determining ownership under subsection (a)(2)(B)(ii)—

"(A) stock held by members of the expanded affiliated group which includes the foreign corporation, or

"(B) stock of such foreign corporation which is sold in a public offering related to the acquisition described in subsection (a)(2)(B)(i).

"(3) PLAN DEEMED IN CERTAIN CASES.—If a foreign corporation acquires directly or indirectly substantially all of the properties of a domestic corporation or partnership during the 4-year period beginning on the date which is 2 years before the ownership requirements of subsection (a)(2)(B)(ii) are met, such actions shall be treated as pursuant to a plan.

"(4) CERTAIN TRANSFERS DISREGARDED.—The transfer of properties or liabilities (including by contribution or distribution) shall be disregarded if such transfers are part of a plan a principal purpose of which is to avoid the purposes of this section.

"(5) SPECIAL RULE FOR RELATED PARTNERSHIPS.—For purposes of applying subsection (a)(2)(B)(ii) to the acquisition of a trade or business of a domestic partnership, except as provided in regulations, all partnerships which are under common control (within the meaning of section 482) shall be treated as 1 partnership.

"(6) REGULATIONS.—The Secretary shall prescribe such regulations as may be appropriate to determine whether a corporation is a surrogate foreign corporation, including regulations—

"(A) to treat warrants, options, contracts to acquire stock, convertible debt interests, and other similar interests as stock, and

"(B) to treat stock as not stock.

"(c) OTHER DEFINITIONS.—For purposes of this section—

"(1) APPLICABLE PERIOD.—The term 'applicable period' means the period—

"(A) beginning on the first date properties are acquired as part of the acquisition described in subsection (a)(2)(B)(i), and

"(B) ending on the date which is 10 years after the last date properties are acquired as part of such acquisition.

"(2) INVERSION GAIN.—The term 'inversion gain' means the income or gain recognized by reason of the transfer during the applicable period of stock or other properties by an expatriated entity, and any income received or accrued during the applicable period by reason of a license of any property by an expatriated entity —

"(A) as part of the acquisition described in subsection (a)(2)(B)(i), or

"(B) after such acquisition if the transfer or license is to a foreign related person.

Subparagraph (B) shall not apply to property described in section 1221(a)(1) in the hands of the expatriated entity.

"(3) FOREIGN RELATED PERSON.—The term 'foreign related person' means, with respect to any expatriated entity, a foreign person which—

"(A) is related (within the meaning of section 267(b) or 707(b)(1)) to such entity, or

"(B) is under the same common control (within the meaning of section 482) as such entity.

"(d) SPECIAL RULES.—

"(1) CREDITS NOT ALLOWED AGAINST TAX ON INVERSION GAIN.—Credits (other than the credit allowed by section 901) shall be allowed against the tax imposed by this chapter on an expatriated entity for any taxable year described in subsection (a) only to the extent such tax exceeds the product of—

"(A) the amount of the inversion gain for the taxable year, and

"(B) the highest rate of tax specified in section 11(b)(1).

For purposes of determining the credit allowed by section 901, inversion gain shall be treated as from sources within the United States.

"(2) SPECIAL RULES FOR PARTNERSHIPS.—In the case of an expatriated entity which is a partnership—

"(A) subsection (a)(1) shall apply at the partner rather than the partnership level,

"(B) the inversion gain of any partner for any taxable year shall be equal to the sum of—

"(i) the partner's distributive share of inversion gain of the partnership for such taxable year, plus

"(ii) gain recognized for the taxable year by the partner by reason of the transfer during the applicable period of any partnership interest of the partner in such partnership to the surrogate foreign corporation, and

"(C) the highest rate of tax specified in the rate schedule applicable to the partner under this chapter shall be substituted for the rate of tax referred to in paragraph (1).

"(3) COORDINATION WITH SECTION 172 AND MINIMUM TAX.—Rules similar to the rules of paragraphs (3) and (4) of section 860E(a) shall apply for purposes of subsection (a).

"(4) STATUTE OF LIMITATIONS.—

"(A) IN GENERAL.—The statutory period for the assessment of any deficiency attributable to the inversion gain of any taxpayer for any pre-inversion year shall not expire before the expiration of 3 years from the date the Secretary is notified by the taxpayer (in such manner as the Secretary may prescribe) of the acquisition described in subsection (a)(2)(B)(i) to which such gain relates and such deficiency may be assessed before the expiration of such 3-year period notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment.

"(B) PRE-INVERSION YEAR.—For purposes of subparagraph (A), the term 'pre-inversion year' means any taxable year if—

"(i) any portion of the applicable period is included in such taxable year, and

"(ii) such year ends before the taxable year in which the acquisition described in subsection (a)(2)(B)(i) is completed.

"(e) SPECIAL RULE FOR TREATIES.—Nothing in section 894 or 7852(d) or in any other provision of law shall be construed as permitting an exemption, by reason of any treaty obligation of the United States heretofore or hereafter entered into, from the provisions of this section.

"(f) REGULATIONS.—The Secretary shall provide such regulations as are necessary to carry out this section, including regulations providing for such adjustments to the application of this section as are necessary to prevent the avoidance of the purposes of this section, including the avoidance of such purposes through—

"(1) the use of related persons, pass-through or other noncorporate entities, or other intermediaries, or

"(2) transactions designed to have persons cease to be (or not become) members of expanded affiliated groups or related persons.".

(b) CONFORMING AMENDMENT.—The table of sections for subchapter C of chapter 80 is amended by adding at the end the following new item:

"Sec. 7874. Rules relating to expatriated entities and their foreign parents."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years ending after March 4, 2003.

SEC. 2003. EXCISE TAX ON STOCK COMPENSATION OF INSIDERS IN EXPATRIATED CORPORATIONS.

(a) IN GENERAL.—Subtitle D is amended by inserting after chapter 44 end the following new chapter:

"CHAPTER 45—PROVISIONS RELATING TO EXPATRIATED ENTITIES

"SEC. 4985. STOCK COMPENSATION OF INSIDERS IN EXPATRIATED CORPORATIONS.

"(a) IMPOSITION OF TAX.—In the case of an individual who is a disqualified individual with respect to any expatriated corporation, there is hereby imposed on such person a tax equal to 15 percent of the value (determined under subsection (b)) of the specified stock compensation held (directly or indirectly) by or for the benefit of such individual or a member of such individual's family (as defined in section 267) at any time during the 12-month period beginning on the date which is 6 months before the expatriation date.

"(b) VALUE.—For purposes of subsection (a)—

"(1) IN GENERAL.—The value of specified stock compensation shall be—

"(A) in the case of a stock option (or other similar right) or a stock appreciation right, the fair value of such option or right, and

"(B) in any other case, the fair market value of such compensation.

"(2) DATE FOR DETERMINING VALUE.—The determination of value shall be made—

"(A) in the case of specified stock compensation held on the expatriation date, on such date,

"(B) in the case of such compensation which is canceled during the 6 months before the expatriation date, on the day before such cancellation, and

"(C) in the case of such compensation which is granted after the expatriation date, on the date such compensation is granted.

"(c) TAX TO APPLY ONLY IF SHAREHOLDER GAIN RECOGNIZED.—Subsection (a) shall apply to any disqualified individual with respect to an expatriated corporation only if gain (if any) on any stock in such corporation is recognized in whole or part by any shareholder by reason of the acquisition referred to in section 7874(a)(2)(B)(i) with respect to such corporation.

"(d) EXCEPTION WHERE GAIN RECOGNIZED ON COMPENSATION.—Subsection (a) shall not apply to—

"(1) any stock option which is exercised on the expatriation date or during the 6-month period before such date and to the stock acquired in such exercise, if income is recognized under section 83 on or before the expatriation date with respect to the stock acquired pursuant to such exercise, and

"(2) any other specified stock compensation which is exercised, sold, exchanged, distributed, cashed-out, or otherwise paid during such period in a transaction in which income, gain, or loss is recognized in full.

"(e) DEFINITIONS.—For purposes of this section—

"(1) DISQUALIFIED INDIVIDUAL.—The term 'disqualified individual' means, with respect to a corporation, any individual who, at any time during the 12-month period beginning on the date which is 6 months before the expatriation date—

"(A) is subject to the requirements of section 16(a) of the Securities Exchange Act of 1934 with respect to such corporation or any member of the expanded affiliated group which includes such corporation, or

"(B) would be subject to such requirements if such corporation or member were an issuer of equity securities referred to in such section.

"(2) EXPATRIATED CORPORATION; EXPATRIATION DATE.—

"(A) EXPATRIATED CORPORATION.—The term 'expatriated corporation' means any corporation which is an expatriated entity (as defined in section 7874(a)(2)). Such term includes any predecessor or successor of such a corporation.

"(B) EXPATRIATION DATE.—The term 'expatriation date' means, with respect to a corporation, the date on which the corporation first becomes an expatriated corporation.

"(3) SPECIFIED STOCK COMPENSATION.—

"(A) IN GENERAL.—The term 'specified stock compensation' means payment (or right to payment) granted by the expatriated corporation (or by any member of the expanded affiliated group which includes such corporation) to any person in connection with the performance of services by a disqualified individual for such corporation or member if the value of such payment or right is based on (or determined by reference to) the value (or change in value) of stock in such corporation (or any such member).

"(B) EXCEPTIONS.—Such term shall not include—

"(i) any option to which part II of subchapter D of chapter 1 applies, or

"(ii) any payment or right to payment from a plan referred to in section 280G(b)(6).

"(4) EXPANDED AFFILIATED GROUP.—The term 'expanded affiliated group' means an affiliated group (as defined in section 1504(a) without regard to section 1504(b)(3)); except that section 1504(a) shall be applied by substituting 'more than 50 percent' for 'at least 80 percent' each place it appears.

"(f) SPECIAL RULES.—For purposes of this section—

"(1) CANCELLATION OF RESTRICTION.—The cancellation of a restriction which by its terms will never lapse shall be treated as a grant.

"(2) PAYMENT OR REIMBURSEMENT OF TAX BY CORPORATION TREATED AS SPECIFIED STOCK COMPENSATION.—Any payment of the tax imposed by this section directly or indirectly by the expatriated corporation or by any member of the expanded affiliated group which includes such corporation—

"(A) shall be treated as specified stock compensation, and

"(B) shall not be allowed as a deduction under any provision of chapter 1.

"(3) CERTAIN RESTRICTIONS IGNORED.—Whether there is specified stock compensation, and the value thereof, shall be determined without regard to any restriction other than a restriction which by its terms will never lapse.

"(4) PROPERTY TRANSFERS.—Any transfer of property shall be treated as a payment and any right to a transfer of property shall be treated as a right to a payment.

"(5) OTHER ADMINISTRATIVE PROVISIONS.—For purposes of subtitle F, any tax imposed by this section shall be treated as a tax imposed by subtitle A.

"(g) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section."

(b) DENIAL OF DEDUCTION.—

(1) IN GENERAL.—Paragraph (6) of section 275(a) is amended by inserting "45," before "46,".

(2) $1,000,000 LIMIT ON DEDUCTIBLE COMPENSATION REDUCED BY PAYMENT OF EXCISE TAX ON SPECIFIED STOCK COMPENSATION.—Paragraph (4) of section 162(m) is amended by adding at the end the following new subparagraph:

"(G) COORDINATION WITH EXCISE TAX ON SPECIFIED STOCK COMPENSATION.—The dollar limitation contained in paragraph (1) with respect to any covered employee shall be reduced (but not below zero) by the amount of any payment (with respect to such employee) of the tax imposed by section 4985 directly or indirectly by the expatriated corporation (as defined in such section) or by any member of the expanded affiliated group (as defined in such section) which includes such corporation."

(c) CONFORMING AMENDMENTS.—

(1) The last sentence of section 3121(v)(2)(A) is amended by inserting before the period "or to any specified stock compensation (as defined in section 4985) on which tax is imposed by section 4985".

(2) The table of chapters for subtitle D is amended by inserting after the item relating to chapter 44 the following new item:

"Chapter 45. Provisions relating to expatriated entities."

(d) EFFECTIVE DATE.—The amendments made by this section shall take effect on March 4, 2003; except that periods before such date shall not be taken into account in applying the periods in subsections (a) and (e)(1) of section 4985 of the Internal Revenue Code of 1986, as added by this section.

SEC. 2004. REINSURANCE OF UNITED STATES RISKS IN FOREIGN JURISDICTIONS.

(a) IN GENERAL.—Section 845(a) (relating to allocation in case of reinsurance agreement involving tax avoidance or evasion) is amended by striking "source and character" and inserting "amount, source, or character".

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to any risk reinsured after the date of the enactment of this Act.

SEC. 2005. REVISION OF TAX RULES ON EXPATRIATION OF INDIVIDUALS.

(a) EXPATRIATION TO AVOID TAX.—

(1) IN GENERAL.—Subsection (a) of section 877 (relating to treatment of expatriates) is amended to read as follows:

"(a) TREATMENT OF EXPATRIATES.—

"(1) IN GENERAL.—Every nonresident alien individual to whom this section applies and who, within the 10-year period immediately preceding the close of the taxable year, lost United States citizenship shall be taxable for such taxable year in the manner provided in subsection (b) if the tax imposed pursuant to such subsection (after any reduction in such tax under the last sentence of such subsection) exceeds the tax which, without regard to this section, is imposed pursuant to section 871.

"(2) INDIVIDUALS SUBJECT TO THIS SECTION.—This section shall apply to any individual if—

"(A) the average annual net income tax (as defined in section 38(c)(1)) of such individual for the period of 5 taxable years ending before the date of the loss of United States citizenship is greater than $122,000,

"(B) the net worth of the individual as of such date is $2,000,000 or more, or

"(C) such individual fails to certify under penalty of perjury that he has met the requirements of this title for the 5 preceding taxable years or fails to submit such evidence of such compliance as the Secretary may require.

In the case of the loss of United States citizenship in any calendar year after 2003, such $122,000 amount shall be increased by an amount equal to such dollar amount multiplied by the cost-of-living adjustment determined under section 1(f)(3) for such calendar year by substituting '2002' for '1992' in subparagraph (B) thereof. Any increase under the preceding sentence shall be rounded to the nearest multiple of $1,000.".

(2) REVISION OF EXCEPTIONS FROM ALTERNATIVE TAX.—Subsection (c) of section 877 (relating to tax avoidance not presumed in certain cases) is amended to read as follows:

"(c) EXCEPTIONS.—

"(1) IN GENERAL.—Subparagraphs (A) and (B) of subsection (a)(2) shall not apply to an individual described in paragraph (2) or (3).

"(2) DUAL CITIZENS.—

"(A) IN GENERAL.—An individual is described in this paragraph if—

"(i) the individual became at birth a citizen of the United States and a citizen of another country and continues to be a citizen of such other country, and

"(ii) the individual has had no substantial contacts with the United States.

"(B) SUBSTANTIAL CONTACTS.—An individual shall be treated as having no substantial contacts with the United States only if the individual—

"(i) was never a resident of the United States (as defined in section 7701(b)),

"(ii) has never held a United States passport, and

"(iii) was not present in the United States for more than 30 days during any calendar year which is 1 of the 10 calendar years preceding the individual's loss of United States citizenship.

"(3) CERTAIN MINORS.—An individual is described in this paragraph if—

"(A) the individual became at birth a citizen of the United States,

"(B) neither parent of such individual was a citizen of the United States at the time of such birth,

"(C) the individual's loss of United States citizenship occurs before such individual attains age 18½, and

"(D) the individual was not present in the United States for more than 30 days during any calendar year which is 1 of the 10 calendar years preceding the individual's loss of United States citizenship.".

(3) CONFORMING AMENDMENT.—Section 2107(a) is amended to read as follows:

"(a) TREATMENT OF EXPATRIATES.—A tax computed in accordance with the table contained in section 2001 is hereby imposed on the transfer of the taxable estate, determined as provided in section 2106, of every decedent nonresident not a citizen of the United States if the date of death occurs during a taxable year with respect to which the decedent is subject to tax under section 877(b).".

(b) SPECIAL RULES FOR DETERMINING WHEN AN INDIVIDUAL IS NO LONGER A UNITED STATES CITIZEN OR LONG-TERM RESIDENT.—Section 7701 (relating to definitions) is amended by redesignating subsection (n) as subsection (o) and by inserting after subsection (m) the following new subsection:

"(n) SPECIAL RULES FOR DETERMINING WHEN AN INDIVIDUAL IS NO LONGER A UNITED STATES CITIZEN OR LONG-TERM RESIDENT.—An individual who would (but for this subsection) cease to be treated as a citizen or resident of the United States shall continue to be treated as a citizen or resident of the United States, as the case may be, until such individual—

"(1) gives notice of an expatriating act or termination of residency (with the requisite intent to relinquish citizenship or terminate residency) to the Secretary of State or the Secretary of Homeland Security, and

"(2) provides a statement in accordance with section 6039G.".

(c) PHYSICAL PRESENCE IN THE UNITED STATES FOR MORE THAN 30 DAYS.—Section 877 (relating to expatriation to avoid tax) is amended by adding at the end the following new subsection:

"(g) PHYSICAL PRESENCE.—

"(1) IN GENERAL.—This section shall not apply to any individual to whom this section would otherwise apply for any taxable year during the 10-year period referred to in subsection (a) in which such individual is physically present in the United States at any time on more than 30 days in the calendar year ending in such taxable year, and such individual shall be treated for purposes of this title as a citizen or resident of the United States, as the case may be, for such taxable year.

"(2) EXCEPTION.—

"(A) IN GENERAL.—In the case of an individual described in any of the following subparagraphs of this paragraph, a day of physical presence in the United States shall be disregarded if the individual is performing services in the United States on such day for an employer. The preceding sentence shall not apply if—

"(i) such employer is related (within the meaning of section 267 and 707) to such individual, or

"(ii) such employer fails to meet such requirements as the Secretary may prescribe by regulations to prevent the avoidance of the purposes of this paragraph.

Not more than 30 days during any calendar year may be disregarded under this subparagraph.

"(B) INDIVIDUALS WITH TIES TO OTHER COUNTRIES.—An individual is described in this subparagraph if—

"(i) the individual becomes (not later than the close of a reasonable period after loss of United States citizenship or termination of residency) a citizen or resident of the country in which—

"(I) such individual was born,

"(II) if such individual is married, such individual's spouse was born, or

"(III) either of such individual's parents were born, and

"(ii) the individual becomes fully liable for income tax in such country.

"(C) MINIMAL PRIOR PHYSICAL PRESENCE IN THE UNITED STATES.—An individual is described in this subparagraph if, for each year in the 10-year period ending on the date of loss of United States citizenship or termination of residency, the individual was physically present in the United States for 30 days or less. The rule of section 7701(b)(3)(D)(ii) shall apply for purposes of this subparagraph.".

(d) TRANSFERS SUBJECT TO GIFT TAX.—

(1) IN GENERAL.—Subsection (a) of section 2501 (relating to taxable transfers) is amended by striking paragraph (4), by redesignating paragraph (5) as paragraph (4), and by striking paragraph (3) and inserting the following new paragraph:

"(3) EXCEPTION.—

"(A) CERTAIN INDIVIDUALS.—Paragraph (2) shall not apply in the case of a donor to whom section 877(b) applies for the taxable year which includes the date of the transfer.

"(B) CREDIT FOR FOREIGN GIFT TAXES.—The tax imposed by this section solely by reason of this paragraph shall be credited with the amount of any gift tax actually paid to any foreign country in respect of any gift which is taxable under this section solely by reason of this paragraph."

(2) TRANSFERS OF CERTAIN STOCK.—Subsection (a) of section 2501 is amended by adding at the end the following new paragraph:

"(5) TRANSFERS OF CERTAIN STOCK.—

"(A) IN GENERAL.—In the case of a transfer of stock in a foreign corporation described in subparagraph (B) by a donor to whom section 877(b) applies for the taxable year which includes the date of the transfer—

"(i) section 2511(a) shall be applied without regard to whether such stock is situated within the United States, and

"(ii) the value of such stock for purposes of this chapter shall be its U.S.-asset value determined under subparagraph (C).

"(B) FOREIGN CORPORATION DESCRIBED.—A foreign corporation is described in this subparagraph with respect to a donor if—

"(i) the donor owned (within the meaning of section 958(a)) at the time of such transfer 10 percent or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation, and

"(ii) such donor owned (within the meaning of section 958(a)), or is considered to have owned (by applying the ownership rules of section 958(b)), at the time of such transfer, more than 50 percent of—

"(I) the total combined voting power of all classes of stock entitled to vote of such corporation, or

"(II) the total value of the stock of such corporation.

"(C) U.S.-ASSET VALUE.—For purposes of subparagraph (A), the U.S.-asset value of stock shall be the amount which bears the same ratio to the fair market value of such stock at the time of transfer as—

"(i) the fair market value (at such time) of the assets owned by such foreign corporation and situated in the United States, bears to

"(ii) the total fair market value (at such time) of all assets owned by such foreign corporation."

(e) ENHANCED INFORMATION REPORTING FROM INDIVIDUALS LOSING UNITED STATES CITIZENSHIP.—

(1) IN GENERAL.—Subsection (a) of section 6039G is amended to read as follows:

"(a) IN GENERAL.—Notwithstanding any other provision of law, any individual to whom section 877(b) applies for any taxable year shall provide a statement for such taxable year which includes the information described in subsection (b).".

(2) INFORMATION TO BE PROVIDED.—Subsection (b) of section 6039G is amended to read as follows:

"(b) INFORMATION TO BE PROVIDED.—Information required under subsection (a) shall include—

"(1) the taxpayer's TIN,

"(2) the mailing address of such individual's principal foreign residence,

"(3) the foreign country in which such individual is residing,

"(4) the foreign country of which such individual is a citizen,

"(5) information detailing the income, assets, and liabilities of such individual,

"(6) the number of days during any portion of which that the individual was physically present in the United States during the taxable year, and

"(7) such other information as the Secretary may prescribe.".

(3) INCREASE IN PENALTY.—Subsection (d) of section 6039G is amended to read as follows:

"(d) PENALTY.—If—

"(1) an individual is required to file a statement under subsection (a) for any taxable year, and

"(2) fails to file such a statement with the Secretary on or before the date such statement is required to be filed or fails to include all the information required to be shown on the statement or includes incorrect information,

such individual shall pay a penalty of $10,000 unless it is shown that such failure is due to reasonable cause and not to willful neglect.".

(4) CONFORMING AMENDMENT.—Section 6039G is amended by striking subsections (c), (f), and (g) and by redesignating subsections (d) and (e) as subsection (c) and (d), respectively.

(f) EFFECTIVE DATE.—The amendments made by this section shall apply to individuals who expatriate after February 27, 2003.

SEC. 2006. REPORTING OF TAXABLE MERGERS AND ACQUISITIONS.

(a) IN GENERAL.—Subpart B of part III of subchapter A of chapter 61 is amended by inserting after section 6043 the following new section:

"SEC. 6043A. RETURNS RELATING TO TAXABLE MERGERS AND ACQUISITIONS.

"(a) IN GENERAL.—According to the forms or regulations prescribed by the Secretary, the acquiring corporation in any taxable acquisition shall make a return setting forth—

"(1) a description of the acquisition,

"(2) the name and address of each shareholder of the acquired corporation who is required to recognize gain (if any) as a result of the acquisition,

"(3) the amount of money and the fair market value of other property transferred to each such shareholder as part of such acquisition, and

"(4) such other information as the Secretary may prescribe.

To the extent provided by the Secretary, the requirements of this section applicable to the acquiring corporation shall be applicable to the acquired corporation and not to the acquiring corporation.

"(b) NOMINEES.—According to the forms or regulations prescribed by the Secretary—

"(1) REPORTING.—Any person who holds stock as a nominee for another person shall furnish in the manner prescribed by the Secretary to such other person the information provided by the corporation under subsection (d).

"(2) REPORTING TO NOMINEES.—In the case of stock held by any person as a nominee, references in this section (other than in subsection (c)) to a shareholder shall be treated as a reference to the nominee.

"(c) TAXABLE ACQUISITION.—For purposes of this section, the term 'taxable acquisition' means any acquisition by a corporation of stock in or property of another corporation if any shareholder of the acquired corporation is required to recognize gain (if any) as a result of such acquisition.

"(d) STATEMENTS TO BE FURNISHED TO SHAREHOLDERS.—According to the forms or regulations prescribed by the Secretary, every person required to make a return under subsection (a) shall 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 such return with respect to such shareholder, and

"(3) such other information as the Secretary may prescribe.

The written statement required under the preceding sentence shall be furnished to the shareholder on or before January 31 of the year following the calendar year during which the taxable acquisition occurred."

(b) ASSESSABLE PENALTIES.—

(1) Subparagraph (B) of section 6724(d)(1) (relating to definitions) is amended by redesignating clauses (ii) through (xviii) as clauses (iii) through (xix), respectively, and by inserting after clause (i) the following new clause:

"(ii) section 6043A(a) (relating to returns relating to taxable mergers and acquisitions),".

(2) Paragraph (2) of section 6724(d) is amended by redesignating subparagraphs (F) through (BB) as subparagraphs (G) through (CC), respectively, and by inserting after subparagraph (E) the following new subparagraph:

"(F) subsections (b) and (d) of section 6043A (relating to returns relating to taxable mergers and acquisitions).".

(c) CLERICAL AMENDMENT.—The table of sections for subpart B of part III of subchapter A of chapter 61 is amended by inserting after the item relating to section 6043 the following new item:

"Sec. 6043A. Returns relating to taxable mergers and acquisitions.".

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to acquisitions after the date of the enactment of this Act.

SEC. 2007. STUDIES.

(a) TRANSFER PRICING RULES.—The Secretary of the Treasury or the Secretary's delegate shall conduct a study regarding the effectiveness of current transfer pricing rules and compliance efforts in ensuring that cross-border transfers and other related-party transactions, particularly transactions involving intangible assets, service contracts, or leases cannot be used improperly to shift income out of the United States. The study shall include a review of the contemporaneous documentation and penalty rules under section 6662 of the Internal Revenue Code of 1986, a review of the regulatory and administrative guidance implementing the principles of section 482 of such Code to transactions involving intangible property and services and to cost-sharing arrangements, and an examination of whether increased disclosure of cross-border transactions should be required. The study shall set forth specific recommendations to address all abuses identified in the study. Not later than June 30, 2004, such Secretary or delegate shall submit to the Congress a report of such study.

(b) INCOME TAX TREATIES.—The Secretary of the Treasury or the Secretary's delegate shall conduct a study of United States income tax treaties to identify any inappropriate reductions in United States withholding tax that provide opportunities for shifting income out of the United States, and to evaluate whether existing anti-abuse mechanisms are operating properly. The study shall include specific recommendations to address all inappropriate uses of tax treaties. Not later than June 30, 2004, such Secretary or delegate shall submit to the Congress a report of such study.

(c) IMPACT OF CORPORATE EXPATRIATION PROVISIONS.—The Secretary of the Treasury or the Secretary's delegate shall conduct a study of the impact of the provisions of this title on earnings stripping and corporate expatriation. The study shall include such recommendations as such Secretary or delegate may have to improve the impact of such provisions in carrying out the purposes of this title. Not later than December 31, 2005, such Secretary or delegate shall submit to the Congress a report of such study.

TITLE III—PROVISIONS RELATING TO TAX SHELTERS

Subtitle A—Taxpayer-Related Provisions

SEC. 3001. PENALTY FOR FAILING TO DISCLOSE REPORTABLE TRANSACTIONS.

(a) IN GENERAL.—Part I of subchapter B of chapter 68 (relating to assessable penalties) is amended by inserting after section 6707 the following new section:

"SEC. 6707A. PENALTY FOR FAILURE TO INCLUDE REPORTABLE TRANSACTION INFORMATION WITH RETURN.

"(a) IMPOSITION OF PENALTY.—Any person who fails to include on any return or statement any information with respect to a reportable transaction which is required under section 6011 to be included with such return or statement shall pay a penalty in the amount determined under subsection (b).

"(b) AMOUNT OF PENALTY.—

"(1) IN GENERAL.—Except as provided in paragraph (2), the amount of the penalty under subsection (a) shall be—

"(A) $10,000 in the case of a natural person, and

"(B) $50,000 in any other case.

"(2) LISTED TRANSACTION.—The amount of the penalty under subsection (a) with respect to a listed transaction shall be—

"(A) $100,000 in the case of a natural person, and

"(B) $200,000 in any other case.

"(c) DEFINITIONS.—For purposes of this section—

"(1) REPORTABLE TRANSACTION.—The term 'reportable transaction' means any transaction with respect to which information is required to be included with a return or statement because, as determined under regulations prescribed under section 6011, such transaction is of a type which the Secretary determines as having a potential for tax avoidance or evasion.

"(2) LISTED TRANSACTION.—The term '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.

"(d) AUTHORITY TO RESCIND PENALTY.—

"(1) IN GENERAL.—The Commissioner of Internal Revenue may rescind all or any portion of any penalty imposed by this section with respect to any violation if—

"(A) the violation is with respect to a reportable transaction other than a listed transaction, and

"(B) rescinding the penalty would promote compliance with the requirements of this title and effective tax administration.

"(2) NO JUDICIAL APPEAL.—Notwithstanding any other provision of law, any determination under this subsection may not be reviewed in any judicial proceeding.

"(3) RECORDS.—If a penalty is rescinded under paragraph (1), the Commissioner shall place in the file in the Office of the Commissioner the opinion of the Commissioner or the head of the Office of Tax Shelter Analysis with respect to the determination, including—

"(A) a statement of the facts and circumstances relating to the violation,

"(B) the reasons for the rescission, and

"(C) the amount of the penalty rescinded.

"(e) COORDINATION WITH OTHER PENALTIES.—The penalty imposed by this section shall be in addition to any other penalty imposed by this title."

(b) CONFORMING AMENDMENT.—The table of sections for part I of subchapter B of chapter 68 is amended by inserting after the item relating to section 6707 the following:

"Sec. 6707A. Penalty for failure to include reportable transaction information with return."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to returns and statements the due date for which is after the date of the enactment of this Act.

(d) REPORT.—The Commissioner of Internal Revenue shall annually report to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate—

(1) a summary of the total number and aggregate amount of penalties imposed, and rescinded, under section 6707A of the Internal Revenue Code of 1986, and

(2) a description of each penalty rescinded under section 6707(c) of such Code and the reasons therefor.

SEC. 3002. ACCURACY-RELATED PENALTY FOR LISTED TRANSACTIONS, OTHER REPORTABLE TRANSACTIONS HAVING A SIGNIFICANT TAX AVOIDANCE PURPOSE, ETC.

(a) IN GENERAL.—Subchapter A of chapter 68 is amended by inserting after section 6662 the following new section:

"SEC. 6662A. IMPOSITION OF ACCURACY-RELATED PENALTY ON UNDERSTATEMENTS WITH RESPECT TO REPORTABLE TRANSACTIONS.

"(a) IMPOSITION OF PENALTY.—If a taxpayer has a reportable transaction understatement for any taxable year, there shall be added to the tax an amount equal to 20 percent of the amount of such understatement.

"(b) REPORTABLE TRANSACTION UNDERSTATEMENT.—For purposes of this section—

"(1) IN GENERAL.—The term 'reportable transaction understatement' means the sum of—

"(A) the product of—

"(i) the amount of the increase (if any) in taxable income which results from a difference between the proper tax treatment of an item to which this section applies and the taxpayer's treatment of such item (as shown on the taxpayer's return of tax), and

"(ii) the highest rate of tax imposed by section 1 (section 11 in the case of a taxpayer which is a corporation), and

"(B) the amount of the decrease (if any) in the aggregate amount of credits determined under subtitle A which results from a difference between the taxpayer's treatment of an item to which this section applies (as shown on the taxpayer's return of tax) and the proper tax treatment of such item.

For purposes of subparagraph (A), any reduction of 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.

"(2) ITEMS TO WHICH SECTION APPLIES.—This section shall apply to any item which is attributable to—

"(A) any listed transaction, and

"(B) any reportable transaction (other than a listed transaction) if a significant purpose of such transaction is the avoidance or evasion of Federal income tax.

"(c) HIGHER PENALTY FOR NONDISCLOSED TRANSACTIONS.—Subsection (a) shall be applied by substituting '30 percent' for '20 percent' with respect to the portion of any reportable transaction understatement with respect to which the requirement of section 6664(d)(2)(A) is not met.

"(d) DEFINITIONS OF REPORTABLE AND LISTED TRANSACTIONS.—For purposes of this section, the terms 'reportable transaction' and 'listed transaction' have the respective meanings given to such terms by section 6707A(c).

"(e) SPECIAL RULES.—

"(1) COORDINATION WITH PENALTIES, ETC., ON OTHER UNDERSTATEMENTS.—In the case of an understatement (as defined in section 6662(d)(2))—

"(A) the amount of such understatement (determined without regard to this paragraph) shall be increased by the aggregate amount of reportable transaction understatements for purposes of determining whether such understatement is a substantial understatement under section 6662(d)(1), and

"(B) the addition to tax under section 6662(a) shall apply only to the excess of the amount of the substantial understatement (if any) after the application of subparagraph (A) over the aggregate amount of reportable transaction understatements.

"(2) COORDINATION WITH OTHER PENALTIES.—

"(A) APPLICATION OF FRAUD PENALTY.—References to an underpayment in section 6663 shall be treated as including references to a reportable transaction understatement.

"(B) NO DOUBLE PENALTY.—This section shall not apply to any portion of an understatement on which a penalty is imposed under section 6663.

"(3) SPECIAL RULE FOR AMENDED RETURNS.—Except as provided in regulations, in no event shall any tax treatment included with an amendment or supplement to a return of tax be taken into account in determining the amount of any reportable transaction understatement if the amendment or supplement is filed after the earlier of the date the taxpayer is first contacted by the Secretary regarding the examination of the return or such other date as is specified by the Secretary."

(b) DETERMINATION OF OTHER UNDERSTATEMENTS.—Subparagraph (A) of section 6662(d)(2) is amended by adding at the end the following flush sentence:

"The excess under the preceding sentence shall be determined without regard to items to which section 6662A applies."

(c) REASONABLE CAUSE EXCEPTION.—

(1) IN GENERAL.—Section 6664 is amended by adding at the end the following new subsection:

"(d) REASONABLE CAUSE EXCEPTION FOR REPORTABLE TRANSACTION UNDERSTATEMENTS.—

"(1) IN GENERAL.—No penalty shall be imposed under section 6662A with respect to any portion of a reportable transaction understatement if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.

"(2) SPECIAL RULES.—Paragraph (1) shall not apply to any reportable transaction understatement unless—

"(A) the relevant facts affecting the tax treatment of the item are adequately disclosed in accordance with the regulations prescribed under section 6011,

"(B) there is or was substantial authority for such treatment, and

"(C) the taxpayer reasonably believed that such treatment was more likely than not the proper treatment.

A taxpayer failing to adequately disclose in accordance with section 6011 shall be treated as meeting the requirements of subparagraph (A) if the penalty for such failure was rescinded under section 6707A(d).

"(3) RULES RELATING TO REASONABLE BELIEF.—For purposes of paragraph (2)(C)—

"(A) IN GENERAL.—A taxpayer shall be treated as having a reasonable belief with respect to the tax treatment of an item only if such belief—

"(i) is based on the facts and law that exist at the time the return of tax which includes such tax treatment is filed, and

"(ii) relates solely to the taxpayer's chances of success on the merits of such treatment and does not take into account the possibility that a return will not be audited, such treatment will not be raised on audit, or such treatment will be resolved through settlement if it is raised.

"(B) CERTAIN OPINIONS MAY NOT BE RELIED UPON.—

"(i) IN GENERAL.—An opinion of a tax advisor may not be relied upon to establish the reasonable belief of a taxpayer if—

"(I) the tax advisor is described in clause (ii), or

"(II) the opinion is described in clause (iii).

"(ii) DISQUALIFIED TAX ADVISORS.—A tax advisor is described in this clause if the tax advisor—

"(I) is a material advisor (within the meaning of section 6111(b)(1)) and participates in the organization, management, promotion, or sale of the transaction or is related (within the meaning of section 267(b) or 707(b)(1)) to any person who so participates,

"(II) is compensated directly or indirectly by a material advisor with respect to the transaction,

"(III) has a fee arrangement with respect to the transaction which is contingent on all or part of the intended tax benefits from the transaction being sustained, or

"(IV) as determined under regulations prescribed by the Secretary, has a disqualifying financial interest with respect to the transaction.

"(iii) DISQUALIFIED OPINIONS.—For purposes of clause (i), an opinion is disqualified if the opinion—

"(I) is based on unreasonable factual or legal assumptions (including assumptions as to future events),

"(II) unreasonably relies on representations, statements, findings, or agreements of the taxpayer or any other person,

"(III) does not identify and consider all relevant facts, or

"(IV) fails to meet any other requirement as the Secretary may prescribe."

(2) CONFORMING AMENDMENTS.—

(A) Paragraph (1) of section 6664(c) is amended by striking "this part" and inserting "section 6662 or 6663".

(B) The heading for subsection (c) of section 6664 is amended by inserting "FOR UNDERPAYMENTS" after "EXCEPTION".

(d) REDUCTION IN PENALTY FOR SUBSTANTIAL UNDERSTATEMENT OF INCOME TAX NOT TO APPLY TO TAX SHELTERS.—Subparagraph (C) of section 6662(d)(2) (relating to substantial understatement of income tax) is amended to read as follows:

"(C) REDUCTION NOT TO APPLY TO TAX SHELTERS.—

"(i) IN GENERAL.—Subparagraph (B) shall not apply to any item attributable to a tax shelter.

"(ii) TAX SHELTER.—For purposes of clause (i), the term 'tax shelter' means—

"(I) a partnership or other entity,

"(II) any investment plan or arrangement, or

"(III) any other plan or arrangement,

if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax."

(e) CONFORMING AMENDMENTS.—

(1) Sections 461(i)(3)(C), 1274(b)(3), and 7525(b) are each amended by striking "section 6662(d)(2)(C)(iii)" and inserting "section 6662(d)(2)(C)(ii)".

(2) The heading for section 6662 is amended to read as follows:

"SEC. 6662. IMPOSITION OF ACCURACY-RELATED PENALTY ON UNDERPAYMENTS."

(3) The table of sections for part II of subchapter A of chapter 68 is amended by striking the item relating to section 6662 and inserting the following new items:

"Sec. 6662. Imposition of accuracy-related penalty on underpayments.
"Sec. 6662A. Imposition of accuracy-related penalty on understatements with respect to reportable transactions."

(f) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years ending after the date of the enactment of this Act.

SEC. 3003. TAX SHELTER EXCEPTION TO CONFIDENTIALITY PRIVILEGES RELATING TO TAXPAYER COMMUNICATIONS.

(a) IN GENERAL.—Section 7525(b) (relating to section not to apply to communications regarding corporate tax shelters) is amended to read as follows:

"(b) SECTION NOT TO APPLY TO COMMUNICATIONS REGARDING TAX SHELTERS.—The privilege under subsection (a) shall not apply to any written communication which is—

"(1) between a federally authorized tax practitioner and—

"(A) any person,

"(B) any director, officer, employee, agent, or representative of the person, or

"(C) any other person holding a capital or profits interest in the person, and

"(2) in connection with the promotion of the direct or indirect participation of the person in any tax shelter (as defined in section 6662(d)(2)(C)(ii))."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to communications made on or after the date of the enactment of this Act.

SEC. 3004. STATUTE OF LIMITATIONS FOR TAXABLE YEARS FOR WHICH REQUIRED LISTED TRANSACTIONS NOT REPORTED.

(a) IN GENERAL.—Section 6501(c) (relating to exceptions) is amended by adding at the end the following new paragraph:

"(10) LISTED TRANSACTIONS.—If a taxpayer fails to include on any return or statement for any taxable year any information with respect to a listed transaction (as defined in section 6707A(c)(2)) which is required under section 6011 to be included with such return or statement, the time for assessment of any tax imposed by this title with respect to such transaction shall not expire before the date which is 1 year after the earlier of—

"(A) the date on which the Secretary is furnished the information so required, or

"(B) the date that a material advisor (as defined in section 6111) meets the requirements of section 6112 with respect to a request by the Secretary under section 6112(b) relating to such transaction with respect to such taxpayer."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years with respect to which the period for assessing a deficiency did not expire before the date of the enactment of this Act.

SEC. 3005. DISCLOSURE OF REPORTABLE TRANSACTIONS.

(a) IN GENERAL.—Section 6111 (relating to registration of tax shelters) is amended to read as follows:

"SEC. 6111. DISCLOSURE OF REPORTABLE TRANSACTIONS.

"(a) IN GENERAL.—Each material advisor with respect to any reportable transaction shall make a return (in such form as the Secretary may prescribe) setting forth—

"(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.

Such return shall be filed not later than the date specified by the Secretary.

"(b) DEFINITIONS.—For purposes of this section—

"(1) MATERIAL ADVISOR.—

"(A) IN GENERAL.—The term 'material advisor' means any person—

"(i) who provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, or carrying out any reportable transaction, and

"(ii) who directly or indirectly derives gross income in excess of the threshold amount (or such other amount as may be prescribed by the Secretary) for such advice or assistance.

"(B) THRESHOLD AMOUNT.—For purposes of subparagraph (A), the threshold amount is—

"(i) $50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons, and

"(ii) $250,000 in any other case.

"(2) REPORTABLE TRANSACTION.—The term 'reportable transaction' has the meaning given to such term by section 6707A(c).

"(c) REGULATIONS.—The Secretary may prescribe regulations which provide—

"(1) that only 1 person shall be required to meet the requirements of subsection (a) in cases in which 2 or more persons would otherwise be required to meet such requirements,

"(2) exemptions from the requirements of this section, and

"(3) such rules as may be necessary or appropriate to carry out the purposes of this section."

(b) CONFORMING AMENDMENTS.—

(1) The item relating to section 6111 in the table of sections for subchapter B of chapter 61 is amended to read as follows:

"Sec. 6111. Disclosure of reportable transactions."

(2) So much of section 6112 as precedes subsection (c) thereof is amended to read as follows:

"SEC. 6112. MATERIAL ADVISORS OF REPORTABLE TRANSACTIONS MUST KEEP LISTS OF ADVISEES, ETC.

"(a) IN GENERAL.—Each material advisor (as defined in section 6111) with respect to any reportable transaction (as defined in section 6707A(c)) shall (whether or not required to file a return under section 6111 with respect to such transaction) maintain (in such manner as the Secretary may by regulations prescribe) a list—

"(1) identifying each person with respect to whom such advisor acted as a material advisor with respect to such transaction, and

"(2) containing such other information as the Secretary may by regulations require."

(3) Section 6112 is amended—

(A) by redesignating subsection (c) as subsection (b),

(B) by inserting "written" before "request" in subsection (b)(1) (as so redesignated), and

(C) by striking "shall prescribe" in subsection (b)(2) (as so redesignated) and inserting "may prescribe".

(4) The item relating to section 6112 in the table of sections for subchapter B of chapter 61 is amended to read as follows:

"Sec. 6112. Material advisors of reportable transactions must keep lists of advisees, etc."

(5)(A) The heading for section 6708 is amended to read as follows:

"SEC. 6708. FAILURE TO MAINTAIN LISTS OF ADVISEES WITH RESPECT TO REPORTABLE TRANSACTIONS."

(B) The item relating to section 6708 in the table of sections for part I of subchapter B of chapter 68 is amended to read as follows:

"Sec. 6708. Failure to maintain lists of advisees with respect to reportable transactions."

(c) REQUIRED DISCLOSURE NOT SUBJECT TO CLAIM OF CONFIDENTIALITY.—Paragraph (1) of section 6112(b), as redesignated by subsection (b), is amended by adding at the end the following new flush sentence:

"For purposes of this section, the identity of any person on such list shall not be privileged.".

(d) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to transactions with respect to which material aid, assistance, or advice referred to in section 6111(b)(1)(A)(i) of the Internal Revenue Code of 1986 (as added by this section) is provided after the date of the enactment of this Act.

(2) NO CLAIM OF CONFIDENTIALITY AGAINST DISCLOSURE.—The amendment made by subsection (c) shall take effect as if included in the amendments made by section 142 of the Deficit Reduction Act of 1984.

SEC. 3006. FAILURE TO FURNISH INFORMATION REGARDING REPORTABLE TRANSACTIONS.

(a) IN GENERAL.—Section 6707 (relating to failure to furnish information regarding tax shelters) is amended to read as follows:

"SEC. 6707. FAILURE TO FURNISH INFORMATION REGARDING REPORTABLE TRANSACTIONS.

"(a) IN GENERAL.—If a person who is required to file a return under section 6111(a) with respect to any reportable transaction—

"(1) fails to file such return on or before the date prescribed therefor, or

"(2) files false or incomplete information with the Secretary with respect to such transaction,

such person shall pay a penalty with respect to such return in the amount determined under subsection (b).

"(b) AMOUNT OF PENALTY.—

"(1) IN GENERAL.—Except as provided in paragraph (2), the penalty imposed under subsection (a) with respect to any failure shall be $50,000.

"(2) LISTED TRANSACTIONS.—The penalty imposed under subsection (a) with respect to any listed transaction shall be an amount equal to the greater of—

"(A) $200,000, or

"(B) 50 percent of the gross income derived by such person with respect to aid, assistance, or advice which is provided with respect to the listed transaction before the date the return is filed under section 6111.

Subparagraph (B) shall be applied by substituting '75 percent' for '50 percent' in the case of an intentional failure or act described in subsection (a).

"(c) RESCISSION AUTHORITY.—The provisions of section 6707A(d) (relating to authority of Commissioner to rescind penalty) shall apply to any penalty imposed under this section.

"(d) REPORTABLE AND LISTED TRANSACTIONS.—For purposes of this section, the terms 'reportable transaction' and 'listed transaction' have the respective meanings given to such terms by section 6707A(c)."

(b) CLERICAL AMENDMENT.—The item relating to section 6707 in the table of sections for part I of subchapter B of chapter 68 is amended by striking "tax shelters" and inserting "reportable transactions".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to returns the due date for which is after the date of the enactment of this Act.

SEC. 3007. MODIFICATION OF PENALTY FOR FAILURE TO MAINTAIN LISTS OF INVESTORS.

(a) IN GENERAL.—Subsection (a) of section 6708 is amended to read as follows:

"(a) IMPOSITION OF PENALTY.—

"(1) IN GENERAL.—If any person who is required to maintain a list under section 6112(a) fails to make such list available upon written request to the Secretary in accordance with section 6112(b) within 20 business days after the date of such request, such person shall pay a penalty of $10,000 for each day of such failure after such 20th day.

"(2) REASONABLE CAUSE EXCEPTION.—No penalty shall be imposed by paragraph (1) with respect to the failure on any day if such failure is due to reasonable cause.".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to requests made after the date of the enactment of this Act.

SEC. 3008. PENALTY ON PROMOTERS OF TAX SHELTERS.

(a) PENALTY ON PROMOTING ABUSIVE TAX SHELTERS.—Section 6700(a) is amended by adding at the end the following new sentence: "Notwithstanding the first sentence, if an activity with respect to which a penalty imposed under this subsection involves a statement described in paragraph (2)(A), the amount of the penalty shall be equal to 50 percent of the gross income derived (or to be derived) from such activity by the person on which the penalty is imposed."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to activities after the date of the enactment of this Act.

SEC. 3009. MODIFICATIONS OF SUBSTANTIAL UNDERSTATEMENT PENALTY FOR NONREPORTABLE TRANSACTIONS.

(a) SUBSTANTIAL UNDERSTATEMENT OF CORPORATIONS.—Section 6662(d)(1)(B) (relating to special rule for corporations) is amended to read as follows:

"(B) SPECIAL RULE FOR CORPORATIONS.—In the case of a corporation other than an S corporation or a personal holding company (as defined in section 542), there is a substantial understatement of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the lesser of—

"(i) 10 percent of the tax required to be shown on the return for the taxable year (or, if greater, $10,000), or

"(ii) $10,000,000."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

SEC. 3010. MODIFICATION OF ACTIONS TO ENJOIN CERTAIN CONDUCT RELATED TO TAX SHELTERS AND REPORTABLE TRANSACTIONS.

(a) IN GENERAL.—Section 7408 (relating to action to enjoin promoters of abusive tax shelters, etc.) is amended by redesignating subsection (c) as subsection (d) and by striking subsections (a) and (b) and inserting the following new subsections:

"(a) AUTHORITY TO SEEK INJUNCTION.—A civil action in the name of the United States to enjoin any person from further engaging in specified conduct may be commenced at the request of the Secretary. Any action under this section shall be brought in the district court of the United States for the district in which such person resides, has his principal place of business, or has engaged in specified conduct. The court may exercise its jurisdiction over such action (as provided in section 7402(a)) separate and apart from any other action brought by the United States against such person.

"(b) ADJUDICATION AND DECREE.—In any action under subsection (a), if the court finds—

"(1) that the person has engaged in any specified conduct, and

"(2) that injunctive relief is appropriate to prevent recurrence of such conduct, the court may enjoin such person from engaging in such conduct or in any other activity subject to penalty under this title.

"(c) SPECIFIED CONDUCT.—For purposes of this section, the term 'specified conduct' means any action, or failure to take action, subject to penalty under section 6700, 6701, 6707, or 6708."

(b) CONFORMING AMENDMENTS.—

(1) The heading for section 7408 is amended to read as follows:

"SEC. 7408. ACTIONS TO ENJOIN SPECIFIED CONDUCT RELATED TO TAX SHELTERS AND REPORTABLE TRANSACTIONS."

(2) The table of sections for subchapter A of chapter 76 is amended by striking the item relating to section 7408 and inserting the following new item:

"Sec. 7408. Actions to enjoin specified conduct related to tax shelters and reportable transactions."

(c) EFFECTIVE DATE.—The amendment made by this section shall take effect on the day after the date of the enactment of this Act.

SEC. 3011. PENALTY ON FAILURE TO REPORT INTERESTS IN FOREIGN FINANCIAL ACCOUNTS.

(a) IN GENERAL.—Section 5321(a)(5) of title 31, United States Code, is amended to read as follows:

"(5) FOREIGN FINANCIAL AGENCY TRANSACTION VIOLATION.—

"(A) PENALTY AUTHORIZED.—The Secretary of the Treasury may impose a civil money penalty on any person who violates, or causes any violation of, any provision of section 5314.

"(B) AMOUNT OF PENALTY.—

"(i) IN GENERAL.—Except as provided in subparagraph (C), the amount of any civil penalty imposed under subparagraph (A) shall not exceed $5,000.

"(ii) REASONABLE CAUSE EXCEPTION.—No penalty shall be imposed under subparagraph (A) with respect to any violation if—

"(I) such violation was due to reasonable cause, and

"(II) the amount of the transaction or the balance in the account at the time of the transaction was properly reported.

"(C) WILLFUL VIOLATIONS.—In the case of any person willfully violating, or willfully causing any violation of, any provision of section 5314—

"(i) the maximum penalty under subparagraph (B)(i) shall be increased to the greater of—

"(I) $25,000, or

"(II) the amount (not exceeding $100,000) determined under subparagraph (D), and

"(ii) subparagraph (B)(ii) shall not apply.

"(D) AMOUNT.—The amount determined under this subparagraph is—

"(i) in the case of a violation involving a transaction, the amount of the transaction, or

"(ii) in the case of a violation involving a failure to report the existence of an account or any identifying information required to be provided with respect to an account, the balance in the account at the time of the violation."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to violations occurring after the date of the enactment of this Act.

SEC. 3012. REGULATION OF INDIVIDUALS PRACTICING BEFORE THE DEPARTMENT OF THE TREASURY.

(a) CENSURE; IMPOSITION OF PENALTY.—

(1) IN GENERAL.—Section 330(b) of title 31, United States Code, is amended—

(A) by inserting ", or censure," after "Department", and

(B) by adding at the end the following new flush sentence:

"The Secretary may impose a monetary penalty on any representative described in the preceding sentence. If the representative was acting on behalf of an employer or any firm or other entity in connection with the conduct giving rise to such penalty, the Secretary may impose a monetary penalty on such employer, firm, or entity if it knew, or reasonably should have known, of such conduct. Such penalty shall not exceed the gross income derived (or to be derived) from the conduct giving rise to the penalty. Any such penalty imposed on an individual may be in addition to, or in lieu of, any suspension, disbarment, or censure of such individual."

(2) EFFECTIVE DATE.—The amendments made by this subsection shall apply to actions taken after the date of the enactment of this Act.

(b) TAX SHELTER OPINIONS, ETC.—Section 330 of such title 31 is amended by adding at the end the following new subsection:

"(d) Nothing in this section or in any other provision of law shall be construed to limit the authority of the Secretary of the Treasury to impose standards applicable to the rendering of written advice with respect to any entity, transaction plan or arrangement, or other plan or arrangement, which is of a type which the Secretary determines as having a potential for tax avoidance or evasion."

Subtitle B—Other Provisions

SEC. 3021. TREATMENT OF STRIPPED INTERESTS IN BOND AND PREFERRED STOCK FUNDS, ETC.

(a) IN GENERAL.—Section 1286 (relating to tax treatment of stripped bonds) is amended by redesignating subsection (f) as subsection (g) and by inserting after subsection (e) the following new subsection:

"(f) TREATMENT OF STRIPPED INTERESTS IN BOND AND PREFERRED STOCK FUNDS, ETC.—In the case of an account or entity substantially all of the assets of which consist of bonds, preferred stock, or a combination thereof, the Secretary may by regulations provide that rules similar to the rules of this section and 305(e), as appropriate, shall apply to interests in such account or entity to which (but for this subsection) this section or section 305(e), as the case may be, would not apply."

(b) CROSS REFERENCE.—Subsection (e) of section 305 is amended by adding at the end the following new paragraph:

"(7) CROSS REFERENCE.—

"For treatment of stripped interests in certain accounts or entities holding preferred stock, see section 1286(f)."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to purchases and dispositions after the date of the enactment of this Act.

SEC. 3022. MINIMUM HOLDING PERIOD FOR FOREIGN TAX CREDIT ON WITHHOLDING TAXES ON INCOME OTHER THAN DIVIDENDS.

(a) IN GENERAL.—Section 901 is amended by redesignating subsection (l) as subsection (m) and by inserting after subsection (k) the following new subsection:

"(l) MINIMUM HOLDING PERIOD FOR WITHHOLDING TAXES ON GAIN AND INCOME OTHER THAN DIVIDENDS ETC.—

"(1) IN GENERAL.—In no event shall a credit be allowed under subsection (a) for any withholding tax (as defined in subsection (k)) on any item of income or gain with respect to any property if—

"(A) such property is held by the recipient of the item for 15 days or less during the 30-day period beginning on the date which is 15 days before the date on which the right to receive payment of such item arises, or

"(B) to the extent that the recipient of the item is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

This paragraph shall not apply to any dividend to which subsection (k) applies.

"(2) EXCEPTION FOR TAXES PAID BY DEALERS.—

"(A) IN GENERAL.—Paragraph (1) shall not apply to any qualified tax with respect to any property held in the active conduct in a foreign country of a business as a dealer in such property.

"(B) QUALIFIED TAX.—For purposes of subparagraph (A), the term 'qualified tax' means a tax paid to a foreign country (other than the foreign country referred to in subparagraph (A)) if—

"(i) the item to which such tax is attributable is subject to taxation on a net basis by the country referred to in subparagraph (A), and

"(ii) such country allows a credit against its net basis tax for the full amount of the tax paid to such other foreign country.

"(C) DEALER.—For purposes of subparagraph (A), the term 'dealer' means—

"(i) with respect to a security, any person to whom paragraphs (1) and (2) of subsection (k) would not apply by reason of paragraph (4) thereof if such security were stock, and

"(ii) with respect to any other property, any person with respect to whom such property is described in section 1221(a)(1).

"(D) REGULATIONS.—The Secretary may prescribe such regulations as may be appropriate to carry out this paragraph, including regulations to prevent the abuse of the exception provided by this paragraph and to treat other taxes as qualified taxes.

"(3) EXCEPTIONS.—The Secretary may by regulation provide that paragraph (1) shall not apply to property where the Secretary determines that the application of paragraph (1) to such property is not necessary to carry out the purposes of this subsection.

"(4) CERTAIN RULES TO APPLY.—Rules similar to the rules of paragraphs (5), (6), and (7) of subsection (k) shall apply for purposes of this subsection.

"(5) DETERMINATION OF HOLDING PERIOD.—Holding periods shall be determined for purposes of this subsection without regard to section 1235 or any similar rule."

(b) CONFORMING AMENDMENT.—The heading of subsection (k) of section 901 is amended by inserting "ON DIVIDENDS" after "TAXES".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to amounts paid or accrued more than 30 days after the date of the enactment of this Act.

SEC. 3023. DISALLOWANCE OF CERTAIN PARTNERSHIP LOSS TRANSFERS.

(a) TREATMENT OF CONTRIBUTED PROPERTY WITH BUILT-IN LOSS.—Paragraph (1) of section 704(c) is amended by striking "and" at the end of subparagraph (A), by striking the period at the end of subparagraph (B) and inserting ", and", and by adding at the end the following:

"(C) if any property so contributed has a built-in loss—

"(i) such built-in loss shall be taken into account only in determining the amount of items allocated to the contributing partner, and

"(ii) except as provided in regulations, in determining the amount of items allocated to other partners, the basis of the contributed property in the hands of the partnership shall be treated as being equal to its fair market value at the time of contribution.

For purposes of subparagraph (C), the term 'built-in loss' means the excess of the adjusted basis of the property (determined without regard to subparagraph (C)(ii)) over its fair market value at the time of contribution."

(b) ADJUSTMENT TO BASIS OF PARTNERSHIP PROPERTY ON TRANSFER OF PARTNERSHIP INTEREST IF THERE IS SUBSTANTIAL BUILT-IN LOSS.—

(1) ADJUSTMENT REQUIRED.—Subsection (a) of section 743 (relating to optional adjustment to basis of partnership property) is amended by inserting before the period "or unless the partnership has a substantial built-in loss immediately after such transfer".

(2) ADJUSTMENT.—Subsection (b) of section 743 is amended by inserting "or with respect to which there is a substantial built-in loss immediately after such transfer" after "section 754 is in effect".

(3) SUBSTANTIAL BUILT-IN LOSS.—Section 743 is amended by adding at the end the following new subsection:

"(d) SUBSTANTIAL BUILT-IN LOSS.—

"(1) IN GENERAL.—For purposes of this section, a partnership has a substantial built-in loss with respect to a transfer of an interest in a partnership if the partnership's adjusted basis in the partnership property exceeds by more than $250,000 the fair market value of such property.

"(2) REGULATIONS.—The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of paragraph (1) and section 734(d), including regulations aggregating related partnerships and disregarding property acquired by the partnership in an attempt to avoid such purposes."

(4) CLERICAL AMENDMENTS.—

(A) The section heading for section 743 is amended to read as follows:

"SEC. 743. ADJUSTMENT TO BASIS OF PARTNERSHIP PROPERTY WHERE SECTION 754 ELECTION OR SUBSTANTIAL BUILT-IN LOSS."

(B) The table of sections for subpart C of part II of subchapter K of chapter 1 is amended by striking the item relating to section 743 and inserting the following new item:

"Sec. 743. Adjustment to basis of partnership property where section 754 election or substantial built-in loss."

(c) ADJUSTMENT TO BASIS OF UNDISTRIBUTED PARTNERSHIP PROPERTY IF THERE IS SUBSTANTIAL BASIS REDUCTION.—

(1) ADJUSTMENT REQUIRED.—Subsection (a) of section 734 (relating to optional adjustment to basis of undistributed partnership property) is amended by inserting before the period "or unless there is a substantial basis reduction".

(2) ADJUSTMENT.—Subsection (b) of section 734 is amended by inserting "or unless there is a substantial basis reduction" after "section 754 is in effect".

(3) SUBSTANTIAL BASIS REDUCTION.—Section 734 is amended by adding at the end the following new subsection:

"(d) SUBSTANTIAL BASIS REDUCTION.—

"(1) IN GENERAL.—For purposes of this section, there is a substantial basis reduction with respect to a distribution if the sum of the amounts described in subparagraphs (A) and (B) of subsection (b)(2) exceeds $250,000.

"(2) REGULATIONS.—

"For regulations to carry out this subsection, see section 743(d)(2)."

(4) CLERICAL AMENDMENTS.—

(A) The section heading for section 734 is amended to read as follows:

"SEC. 734. ADJUSTMENT TO BASIS OF UNDISTRIBUTED PARTNERSHIP PROPERTY WHERE SECTION 754 ELECTION OR SUBSTANTIAL BASIS REDUCTION."

(B) The table of sections for subpart B of part II of subchapter K of chapter 1 is amended by striking the item relating to section 734 and inserting the following new item:

"Sec. 734. Adjustment to basis of undistributed partnership property where section 754 election or substantial basis reduction."

(d) EFFECTIVE DATES.—

(1) SUBSECTION (a).—The amendment made by subsection (a) shall apply to contributions made after the date of the enactment of this Act.

(2) SUBSECTION (b).—The amendments made by subsection (b) shall apply to transfers after the date of the enactment of this Act.

(3) SUBSECTION (c).—The amendments made by subsection (c) shall apply to distributions after the date of the enactment of this Act.

SEC. 3024. NO REDUCTION OF BASIS UNDER SECTION 734 IN STOCK HELD BY PARTNERSHIP IN CORPORATE PARTNER.

(a) IN GENERAL.—Section 755 is amended by adding at the end the following new subsection:

"(c) NO ALLOCATION OF BASIS DECREASE TO STOCK OF CORPORATE PARTNER.—In making an allocation under subsection (a) of any decrease in the adjusted basis of partnership property under section 734(b)—

"(1) no allocation may be made to stock in a corporation (or any person related (within the meaning of sections 267(b) and 707(b)(1)) to such corporation) which is a partner in the partnership, and

"(2) any amount not allocable to stock by reason of paragraph (1) shall be allocated under subsection (a) to other partnership property.

Gain shall be recognized to the partnership to the extent that the amount required to be allocated under paragraph (2) to other partnership property exceeds the aggregate adjusted basis of such other property immediately before the allocation required by paragraph (2).''

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to distributions after the date of the enactment of this Act.

SEC. 3025. REPEAL OF SPECIAL RULES FOR FASITS.

(a) IN GENERAL.—Part V of subchapter M of chapter 1 (relating to financial asset securitization investment trusts) is hereby repealed.

(b) CONFORMING AMENDMENTS.—

(1) Paragraph (6) of section 56(g) is amended by striking ''REMIC, or FASIT'' and inserting ''or REMIC''.

(2) Clause (ii) of section 382(l)(4)(B) is amended by striking ''a REMIC to which part IV of subchapter M applies, or a FASIT to which part V of subchapter M applies,'' and inserting ''or a REMIC to which part IV of subchapter M applies,''.

(3) Paragraph (1) of section 582(c) is amended by striking '', and any regular interest in a FASIT,''.

(4) Subparagraph (E) of section 856(c)(5) is amended by striking the last sentence.

(5)(A) Section 860G(a)(1) is amended by adding at the end the following new sentence: ''An interest shall not fail to qualify as a regular interest solely because the specified principal amount of the regular interest (or the amount of interest accrued on the regular interest) can be reduced as a result of the nonoccurrence of 1 or more contingent payments with respect to any reverse mortgage loan held by the REMIC if, on the startup day for the REMIC, the sponsor reasonably believes that all principal and interest due under the regular interest will be paid at or prior to the liquidation of the REMIC.''.

(B) The last sentence of section 860G(a)(3) is amended by inserting '', and any reverse mortgage loan (and each balance increase on such loan meeting the requirements of subparagraph (A)(iii)) shall be treated as an obligation secured by an interest in real property'' before the period at the end.

(6) Paragraph (3) of section 860G(a) is amended by adding ''and'' at the end of subparagraph (B), by striking '', and'' at the end of subparagraph (C) and inserting a period, and by striking subparagraph (D).

(7) Section 860G(a)(3) is amended by adding at the end the following new sentence: ''For purposes of subparagraph (A), if more than 50 percent of the obligations transferred to, or purchased by, the REMIC are originated by the United States or any State (or any political subdivision, agency, or instrumentality of the United States or any State) and are principally secured by an interest in real property, then each obligation transferred to, or purchased by, the REMIC shall be treated as secured by an interest in real property.''.

(8)(A) Section 860G(a)(3)(A) is amended by striking ''or'' at the end of clause (i), by inserting ''or'' at the end of clause (ii), and by inserting after clause (ii) the following new clause:

''(iii) represents an increase in the principal amount under the original terms of an obligation described in clause (i) or (ii) if—

''(I) such increase in the balance is attributable to an advance made to the obligor pursuant to the original terms of the obligation,

''(II) such increase in the balance occurs after the startup day, and

''(III) such increase in the balance is purchased by the REMIC pursuant to a fixed price contract in effect on the startup day.''.

(B) Section 860G(a)(7)(B) is amended to read as follows:

''(B) QUALIFIED RESERVE FUND.—For purposes of subparagraph (A), the term 'qualified reserve fund' means any reasonably required reserve to—

''(i) provide for full payment of expenses of the REMIC or amounts due on regular interests in the event of defaults on qualified mortgages or lower than expected returns on cash flow investments, or

''(ii) provide a source of funds for the purchase of obligations described in clause (ii) or (iii) of paragraph (3)(A).

The aggregate fair market value of the assets held in any such reserve shall not exceed 50 percent of the aggregate fair market value of all of the assets of the REMIC on the startup day, and the amount of any such reserve shall be promptly and appropriately reduced to the extent the amount held in such reserve is no longer reasonably required for purposes specified in clause (i) or (ii) of paragraph (3)(A).''.

(9) Subparagraph (C) of section 1202(e)(4) is amended by striking “REMIC, or FASIT” and inserting “or REMIC”.

(10) Section 1272(a)(6)(B) is amended by adding at the end the following new flush sentence:

“For purposes of clause (iii), the Secretary shall prescribe regulations permitting the use of a current prepayment assumption, determined as of the close of the accrual period (or such other time as the Secretary may prescribe during the taxable year in which the accrual period ends).”.

(11) Subparagraph (C) of section 7701(a)(19) is amended by adding “and” at the end of clause (ix), by striking “, and” at the end of clause (x) and inserting a period, and by striking clause (xi).

(12) The table of parts for subchapter M of chapter 1 is amended by striking the item relating to part V.

(c) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to taxable years beginning after December 31, 2003.

(2) EXCEPTION FOR EXISTING FASITS.—

(A) IN GENERAL.—Paragraph (1) shall not apply to any FASIT in existence on the date of the enactment of this Act to the extent that regular interests issued by the FASIT before such date continue to remain outstanding in accordance with the original terms of issuance.

(B) TRANSFER OF ADDITIONAL ASSETS NOT PERMITTED.—Except as provided in regulations prescribed by the Secretary of the Treasury or the Secretary's delegate, subparagraph (A) shall cease to apply as of the earliest date after the date of the enactment of this Act that any property is transferred to the FASIT.

SEC. 3026. LIMITATION ON TRANSFER OF BUILT-IN LOSSES ON REMIC RESIDUALS.

(a) IN GENERAL.—Section 362 (relating to basis to corporations) is amended by adding at the end the following new subsection:

“(e) LIMITATION ON TRANSFER OF BUILT-IN LOSSES ON REMIC RESIDUALS IN SECTION 351 TRANSACTIONS.—If—

“(1) a residual interest (as defined in section 860G(a)(2)) in a REMIC is transferred in any transaction which is described in subsection (a), and

“(2) the transferee's adjusted basis in such residual interest would (but for this paragraph) exceed its fair market value immediately after such transaction,

then, notwithstanding subsection (a), the transferee's adjusted basis in such residual interest shall not exceed its fair market value (whether or not greater than zero) immediately after such transaction.”

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to transactions after the date of the enactment of this Act.

SEC. 3027. CLARIFICATION OF BANKING BUSINESS FOR PURPOSES OF DETERMINING INVESTMENT OF EARNINGS IN UNITED STATES PROPERTY.

(a) IN GENERAL.—Subparagraph (A) of section 956(c)(2) is amended to read as follows:

“(A) obligations of the United States, money, or deposits with any corporation with respect to which a bank holding company (within the meaning of section 2(a) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(a))) or financial holding company (within the meaning of section 2(p) of such Act) owns directly or indirectly more than 80 percent by vote or value of the stock of such corporation;”.

(b) EFFECTIVE DATE.—The amendment made by this section shall take effect on the date of the enactment of this Act.

SEC. 3028. MODIFICATIONS RELATED TO CERTAIN SMALL INSURANCE COMPANIES.

(a) EXEMPTION FOR SMALL PROPERTY AND CASUALTY INSURANCE COMPANIES.—

(1) IN GENERAL.—Section 501(c)(15)(A) is amended to read as follows:

“(A) Insurance companies (as defined in section 816(a)) other than life (including interinsurers and reciprocal underwriters) if—

“(i) the gross receipts for the taxable year do not exceed $600,000, and

“(ii) more than 50 percent of such gross receipts consist of premiums.”.

(2) CONTROLLED GROUP RULE.—Section 501(c)(15)(C) is amended by inserting “, except that in applying section 1563 for purposes of section 831(b)(2)(B)(ii), subparagraphs (B) and (C) of section 1563(b)(2) shall be disregarded” before the period at the end.

(3) CONFORMING AMENDMENT.—Clause (i) of section 831(b)(2)(A) is amended by striking “exceed $350,000 but”.

(b) ALTERNATIVE TAX FOR CERTAIN SMALL INSURANCE COMPANIES.—

(1) INCREASED LIMITATION.—Clause (i) of section 831(b)(2)(A) is amended by striking "$1,200,000" and inserting "$1,890,000".

(2) INFLATION ADJUSTMENT.—Paragraph (2) of section 831(b) is amended by adding at the end the following new subparagraph:

"(C) INFLATION ADJUSTMENT.—In the case of any taxable year beginning in a calendar year after 2004, the $1,890,000 amount in subparagraph (A) shall be increased by an amount equal to—

"(i) $1,890,000, multiplied by

"(ii) the cost-of-living adjustment determined under section 1(f)(3) for such calendar year by substituting 'calendar year 2003' for 'calendar year 1992' in subparagraph (B) thereof.

If the amount as adjusted under the preceding sentence is not a multiple of $1,000, such amount shall be rounded to the next lowest multiple of $1,000.".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2003.

SEC. 3029. DEFINITION OF INSURANCE COMPANY FOR SECTION 831.

(a) IN GENERAL.—Section 831 is amended by redesignating subsection (c) as subsection (d) and by inserting after subsection (b) the following new subsection:

"(c) INSURANCE COMPANY DEFINED.—For purposes of this section, the term 'insurance company' has the meaning given to such term by section 816(a)."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years beginning after December 31, 2003.

SEC. 3030. DENIAL OF DEDUCTION FOR INTEREST ON UNDERPAYMENTS ATTRIBUTABLE TO NONDISCLOSED REPORTABLE TRANSACTIONS.

(a) IN GENERAL.—Section 163 (relating to deduction for interest) is amended by redesignating subsection (m) as subsection (n) and by inserting after subsection (l) the following new subsection:

"(m) INTEREST ON UNPAID TAXES ATTRIBUTABLE TO NONDISCLOSED REPORTABLE TRANSACTIONS.—No deduction shall be allowed under this chapter for any interest paid or accrued under section 6601 on any underpayment of tax which is attributable to the portion of any reportable transaction understatement (as defined in section 6662A(b)) with respect to which the requirement of section 6664(d)(2)(A) is not met.".

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to transactions in taxable years beginning after the date of the enactment of this Act.

SEC. 3031. CLARIFICATION OF RULES FOR PAYMENT OF ESTIMATED TAX FOR CERTAIN DEEMED ASSET SALES.

(a) IN GENERAL.—Paragraph (13) of section 338(h) (relating to tax on deemed sale not taken into account for estimated tax purposes) is amended by adding at the end the following: "The preceding sentence shall not apply with respect to a qualified stock purchase for which an election is made under paragraph (10).".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to transactions occurring after the date of the enactment of this Act.

SEC. 3032. RECOGNITION OF GAIN FROM THE SALE OF A PRINCIPAL RESIDENCE ACQUIRED IN A LIKE-KIND EXCHANGE WITHIN 5 YEARS OF SALE.

(a) IN GENERAL.—Section 121(d) (relating to special rules for exclusion of gain from sale of principal residence) is amended by adding at the end the following new paragraph:

"(10) PROPERTY ACQUIRED IN LIKE-KIND EXCHANGE.—If a taxpayer acquired property in an exchange to which section 1031 applied, subsection (a) shall not apply to the sale or exchange of such property if it occurs during the 5-year period beginning with the date of the acquisition of such property.".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to sales or exchanges after the date of the enactment of this Act.

SEC. 3033. PREVENTION OF MISMATCHING OF INTEREST AND ORIGINAL ISSUE DISCOUNT DEDUCTIONS AND INCOME INCLUSIONS IN TRANSACTIONS WITH RELATED FOREIGN PERSONS.

(a) ORIGINAL ISSUE DISCOUNT.—Section 163(e)(3) (relating to special rule for original issue discount on obligation held by related foreign person) is amended by redesignating subparagraph (B) as subparagraph (C) and by inserting after subparagraph (A) the following new subparagraph:

"(B) SPECIAL RULE FOR CERTAIN FOREIGN ENTITIES.—

"(i) IN GENERAL.—In the case of any debt instrument having original issue discount which is held by a related foreign person which is a foreign personal holding company (as defined in section 552), a controlled foreign corporation (as defined in section 957), or a passive foreign investment company (as defined in section 1297), a deduction shall be allowable to the issuer with respect to such original issue discount for any taxable year before the taxable year in which paid only to the extent such original issue discount is included during such prior taxable year in the gross income of a United States person who owns (within the meaning of section 958(a)) stock in such corporation.

"(ii) SECRETARIAL AUTHORITY.—The Secretary may by regulation exempt transactions from the application of clause (i), including any transaction which is entered into by a payor in the ordinary course of a trade or business in which the payor is predominantly engaged.".

(b) INTEREST AND OTHER DEDUCTIBLE AMOUNTS.—Section 267(a)(3) is amended—

(1) by striking "The Secretary" and inserting:

"(A) IN GENERAL.—The Secretary", and

(2) by adding at the end the following new subparagraph:

"(B) SPECIAL RULE FOR CERTAIN FOREIGN ENTITIES.—

"(i) IN GENERAL.—Notwithstanding subparagraph (A), in the case of any amount payable to a foreign personal holding company (as defined in section 552), a controlled foreign corporation (as defined in section 957), or a passive foreign investment company (as defined in section 1297), a deduction shall be allowable to the payor with respect to such amount for any taxable year before the taxable year in which paid only to the extent such amount is included during such prior taxable year in the gross income of a United States person who owns (within the meaning of section 958(a)) stock in such corporation.

"(ii) SECRETARIAL AUTHORITY.—The Secretary may by regulation exempt transactions from the application of clause (i), including any transaction which is entered into by a payor in the ordinary course of a trade or business in which the payor is predominantly engaged and in which the payment of the accrued amounts occurs within 8½ months after accrual or within such other period as the Secretary may prescribe.".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to payments accrued on or after the date of the enactment of this Act.

SEC. 3034. EXCLUSION FROM GROSS INCOME FOR INTEREST ON OVERPAYMENTS OF INCOME TAX BY INDIVIDUALS.

(a) IN GENERAL.—Part III of subchapter B of chapter 1 (relating to items specifically excluded from gross income) is amended by inserting after section 139A the following new section:

"SEC. 139B. EXCLUSION FROM GROSS INCOME FOR INTEREST ON OVERPAYMENTS OF INCOME TAX BY INDIVIDUALS.

"(a) IN GENERAL.—In the case of an individual, gross income shall not include interest paid under section 6611 on any overpayment of tax imposed by this subtitle.

"(b) EXCEPTION.—Subsection (a) shall not apply in the case of a failure to claim items resulting in the overpayment on the original return if the Secretary determines that the principal purpose of such failure is to take advantage of subsection (a).

"(c) SPECIAL RULE FOR DETERMINING MODIFIED ADJUSTED GROSS INCOME.—For purposes of this title, interest not included in gross income under subsection (a) shall not be treated as interest which is exempt from tax for purposes of sections 32(i)(2)(B) and 6012(d) or any computation in which interest exempt from tax under this title is added to adjusted gross income.".

(b) CLERICAL AMENDMENT.—The table of sections for part III of subchapter B of chapter 1 is amended by inserting after the item relating to section 139A the following new item:

"Sec. 139B. Exclusion from gross income for interest on overpayments of income tax by individuals.".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to interest received in calendar years beginning after the date of the enactment of this Act.

SEC. 3035. DEPOSITS MADE TO SUSPEND RUNNING OF INTEREST ON POTENTIAL UNDERPAYMENTS.

(a) IN GENERAL.—Subchapter A of chapter 67 (relating to interest on underpayments) is amended by adding at the end the following new section:

"SEC. 6603. DEPOSITS MADE TO SUSPEND RUNNING OF INTEREST ON POTENTIAL UNDERPAYMENTS, ETC.

"(a) AUTHORITY TO MAKE DEPOSITS OTHER THAN AS PAYMENT OF TAX.—A taxpayer may make a cash deposit with the Secretary which may be used by the Secretary to pay any tax imposed under subtitle A or B or chapter 41, 42, 43, or 44 which has not been assessed at the time of the deposit. Such a deposit shall be made in such manner as the Secretary shall prescribe.

"(b) NO INTEREST IMPOSED.—To the extent that such deposit is used by the Secretary to pay tax, for purposes of section 6601 (relating to interest on underpayments), the tax shall be treated as paid when the deposit is made.

"(c) RETURN OF DEPOSIT.—Except in a case where the Secretary determines that collection of tax is in jeopardy, the Secretary shall return to the taxpayer any amount of the deposit (to the extent not used for a payment of tax) which the taxpayer requests in writing.

"(d) PAYMENT OF INTEREST.—

"(1) IN GENERAL.—For purposes of section 6611 (relating to interest on overpayments), a deposit which is returned to a taxpayer shall be treated as a payment of tax for any period to the extent (and only to the extent) attributable to a disputable tax for such period. Under regulations prescribed by the Secretary, rules similar to the rules of section 6611(b)(2) shall apply.

"(2) DISPUTABLE TAX.—

"(A) IN GENERAL.—For purposes of this section, the term 'disputable tax' means the amount of tax specified at the time of the deposit as the taxpayer's reasonable estimate of the maximum amount of any tax attributable to disputable items.

"(B) SAFE HARBOR BASED ON 30-DAY LETTER.—In the case of a taxpayer who has been issued a 30-day letter, the maximum amount of tax under subparagraph (A) shall not be less than the amount of the proposed deficiency specified in such letter.

"(3) OTHER DEFINITIONS.—For purposes of paragraph (2)—

"(A) DISPUTABLE ITEM.—The term 'disputable item' means any item of income, gain, loss, deduction, or credit if the taxpayer—

"(i) has a reasonable basis for its treatment of such item, and

"(ii) reasonably believes that the Secretary also has a reasonable basis for disallowing the taxpayer's treatment of such item.

"(B) 30-DAY LETTER.—The term '30-day letter' means the first letter of proposed deficiency which allows the taxpayer an opportunity for administrative review in the Internal Revenue Service Office of Appeals.

"(4) RATE OF INTEREST.—The rate of interest allowable under this subsection shall be the Federal short-term rate determined under section 6621(b), compounded daily.

"(e) USE OF DEPOSITS.—

"(1) PAYMENT OF TAX.—Except as otherwise provided by the taxpayer, deposits shall be treated as used for the payment of tax in the order deposited.

"(2) RETURNS OF DEPOSITS.—Deposits shall be treated as returned to the taxpayer on a last-in, first-out basis.".

(b) CLERICAL AMENDMENT.—The table of sections for subchapter A of chapter 67 is amended by adding at the end the following new item:

"Sec. 6603. Deposits made to suspend running of interest on potential underpayments, etc.".

(c) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendments made by this section shall apply to deposits made after the date of the enactment of this Act.

(2) COORDINATION WITH DEPOSITS MADE UNDER REVENUE PROCEDURE 84–58.—In the case of an amount held by the Secretary of the Treasury or his delegate on the date of the enactment of this Act as a deposit in the nature of a cash bond deposit pursuant to Revenue Procedure 84–58, the date that the taxpayer identifies such amount as a deposit made pursuant to section 6603 of the Internal Revenue Code (as added by this Act) shall be treated as the date such amount is deposited for purposes of such section 6603.

SEC. 3036. PARTIAL PAYMENT OF TAX LIABILITY IN INSTALLMENT AGREEMENTS.

(a) IN GENERAL.—

(1) Section 6159(a) (relating to authorization of agreements) is amended—

(A) by striking "satisfy liability for payment of" and inserting "make payment on", and

(B) by inserting "full or partial" after "facilitate".

(2) Section 6159(c) (relating to Secretary required to enter into installment agreements in certain cases) is amended in the matter preceding paragraph (1) by inserting "full" before "payment".

(b) REQUIREMENT TO REVIEW PARTIAL PAYMENT AGREEMENTS EVERY TWO YEARS.—Section 6159 is amended by redesignating subsections (d) and (e) as subsections (e) and (f), respectively, and inserting after subsection (c) the following new subsection:

"(d) SECRETARY REQUIRED TO REVIEW INSTALLMENT AGREEMENTS FOR PARTIAL COLLECTION EVERY TWO YEARS.—In the case of an agreement entered into by the Secretary under subsection (a) for partial collection of a tax liability, the Secretary shall review the agreement at least once every 2 years.".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to agreements entered into on or after the date of the enactment of this Act.

SEC. 3037. EXTENSION OF IRS USER FEES.

(a) IN GENERAL.—Section 7528(c) (relating to termination) is amended by striking "December 31, 2004" and inserting "September 30, 2013".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to requests after the date of the enactment of this Act.

TITLE IV—TRADE ENHANCEMENT AND COMPLIANCE PROVISIONS

SEC. 4001. REPEAL OF EXCLUSION FOR EXTRATERRITORIAL INCOME.

(a) IN GENERAL.—Section 114 is hereby repealed.

(b) CONFORMING AMENDMENTS.—

(1) Subpart E of part III of subchapter N of chapter 1 (relating to qualifying foreign trade income) is hereby repealed.

(2) The table of subparts for such part III is amended by striking the item relating to subpart E.

(3) The table of sections for part III of subchapter B of chapter 1 is amended by striking the item relating to section 114.

(c) EFFECTIVE DATE.—Except as provided in subsection (d), the amendments made by this section shall apply to transactions after December 31, 2003.

(d) TRANSITIONAL RULE FOR 2004, 2005, AND 2006.—

(1) IN GENERAL.—In the case of transactions during 2004, 2005, or 2006, the amount includible in gross income by reason of the amendments made by this section shall not exceed the applicable percentage of the amount which would have been so included but for this subsection.

(2) APPLICABLE PERCENTAGE.—For purposes of paragraph (1), the applicable percentage shall be as follows:

(A) For 2004, the applicable percentage shall be 20 percent.

(B) For 2005, the applicable percentage shall be 20 percent.

(C) For 2006, the applicable percentage shall be 40 percent.

(e) REVOCATION OF ELECTION TO BE TREATED AS DOMESTIC CORPORATION.—If, during the 1-year period beginning on the date of the enactment of this Act, a corporation for which an election is in effect under section 943(e) of the Internal Revenue Code of 1986 revokes such election, no gain or loss shall be recognized with respect to property treated as transferred under clause (ii) of section 943(e)(4)(B) of such Code to the extent such property—

(1) was treated as transferred under clause (i) thereof, or

(2) was acquired during a taxable year to which such election applies and before May 1, 2003, in the ordinary course of its trade or business.

The Secretary of the Treasury (or such Secretary's delegate) may prescribe such regulations as may be necessary to prevent the abuse of the purposes of this subsection.

(f) BINDING CONTRACTS.—The amendments made by this section shall not apply to any transaction in the ordinary course of a trade or business which occurs pursuant to a binding contract—

(1) which is between the taxpayer and a person who is not a related person (as defined in section 943(b)(3) of such Code, as in effect on the day before the date of the enactment of this Act), and

(2) which is in effect on January 14, 2002, and at all times thereafter.

For purposes of this subsection, a binding contract shall include a purchase option, renewal option, or replacement option which is included in such contract and which is enforceable against the seller or lessor.

SEC. 4002. COBRA FEES.

(a) USE OF MERCHANDISE PROCESSING FEE.—Section 13031(f) of the Consolidated Omnibus Budget Reconciliation Act of 1985 (19 U.S.C. 58c(f)) is amended—

(1) in paragraph (1), by aligning subparagraph (B) with subparagraph (A); and

(2) in paragraph (2), by striking "commercial operations" and all that follows through "processing." and inserting "customs revenue functions as defined in section 415 of the Homeland Security Act of 2002 (other than functions performed by the Office of International Affairs referred to in section 415(8) of that Act), and for automation (including the Automation Commercial Environment computer system), and for no other purpose. To the extent that funds in the Customs User Fee Account are insufficient to pay the costs of such customs revenue functions, customs duties in an amount equal to the amount of such insufficiency shall be available, to the extent provided for in appropriations Acts, to pay the costs of such customs revenue functions in the amount of such insufficiency, and shall be available for no other purpose. The provisions of the first and second sentences of this paragraph specifying the purposes for which amounts in the Customs User Fee Account may be made available shall not be superseded except by a provision of law which specifically modifies or supersedes such provisions.".

(b) REIMBURSEMENT OF APPROPRIATIONS FROM COBRA FEES.—Section 13031(f)(3) of the Consolidated Omnibus Budget Reconciliation Act of 1985 (19 U.S.C. 58c(f)(3)) is amended by adding at the end the following:

"(E) Nothing in this paragraph shall be construed to preclude the use of appropriated funds, from sources other than the fees collected under subsection (a), to pay the costs set forth in clauses (i), (ii), and (iii) of subparagraph (A).".

(c) SENSE OF CONGRESS; EFFECTIVE PERIOD FOR COLLECTING FEES; STANDARD FOR SETTING FEES.—

(1) SENSE OF CONGRESS.—The Congress finds that—

(A) the fees set forth in paragraphs (1) through (8) of subsection (a) of section 13031 of the Consolidated Omnibus Budget Reconciliation Act of 1985 have been reasonably related to the costs of providing customs services in connection with the activities or items for which the fees have been charged under such paragraphs; and

(B) the fees collected under such paragraphs have not exceeded, in the aggregate, the amounts paid for the costs described in subsection (f)(3)(A) incurred in providing customs services in connection with the activities or items for which the fees were charged under such paragraphs.

(2) EFFECTIVE PERIOD; STANDARD FOR SETTING FEES.—Section 13031(j)(3) of the Consolidated Omnibus Budget Reconciliation Act of 1985 is amended to read as follows:

"(3)(A) Fees may not be charged under paragraphs (9) and (10) of subsection (a) after September 30, 2013.

"(B)(i) Subject to clause (ii), Fees may not be charged under paragraphs (1) through (8) of subsection (a) after September 30, 2013.

"(ii) In fiscal year 2006 and in each succeeding fiscal year for which fees under paragraphs (1) through (8) of subsection (a) are authorized—

"(I) the Secretary of the Treasury shall charge fees under each such paragraph in amounts that are reasonably related to the costs of providing customs services in connection with the activity or item for which the fee is charged under such paragraph, except that in no case may the fee charged under any such paragraph exceed by more than 10 percent the amount otherwise prescribed by such paragraph;

"(II) the amount of fees collected under such paragraphs may not exceed, in the aggregate, the amounts paid in that fiscal year for the costs described in subsection (f)(3)(A) incurred in providing customs services in connection with the activity or item for which the fees are charged under such paragraphs;

"(III) a fee may not be collected under any such paragraph except to the extent such fee will be expended to pay the costs described in subsection (f)(3)(A) incurred in providing customs services in connection with the activity or item for which the fee is charged under such paragraph; and

"(IV) any fee collected under any such paragraph shall be available for expenditure only to pay the costs described in subsection (f)(3)(A) incurred in providing customs services in connection with the activity or item for which the fee is charged under such paragraph.".

(d) CLERICAL AMENDMENTS.—Section 13031 of the Consolidated Omnibus Budget Reconciliation Act of 1985 is amended—

(1) in subsection (a)(5)(B), by striking "$1.75" and inserting "$1.75.";

(2) in subsection (b)—

(A) in paragraph (1)(A), by aligning clause (iii) with clause (ii);

(B) in paragraph (7), by striking "paragraphs" and inserting "paragraph"; and

(C) in paragraph (9), by aligning subparagraph (B) with subparagraph (A); and

(3) in subsection (e)(2), by aligning subparagraph (B) with subparagraph (A).

(e) STUDY OF ALL FEES COLLECTED BY DEPARTMENT OF HOMELAND SECURITY.—The Secretary of the Treasury shall conduct a study of all the fees collected by the Department of Homeland Security, and shall submit to the Congress, not later than September 30, 2005, a report containing the recommendations of the Secretary on—

(1) what fees should be eliminated;

(2) what the rate of fees retained should be; and

(3) any other recommendations with respect to the fees that the Secretary considers appropriate.

I . SUMMARY AND BACKGROUND

A. PURPOSE AND SUMMARY

The bill, H.R. 2896, as amended, (the "American Jobs Creation Act of 2003") repeals the exclusion for extraterritorial income, provides a reduced corporate income tax rate for domestic production activities, makes U.S. companies competitive in the United States and globally, and provides other corporate reform and growth incentives.

The bill provides net tax reductions of over $21.136 billion over fiscal years 2004–2008.

B. BACKGROUND AND NEED FOR LEGISLATION

The provisions approved by the Committee bring U.S. tax law into compliance with the WTO Appellate Body holding that the ETI regime constitutes a prohibited export subsidy under the relevant trade agreements. The provisions approved by the Committee provide corporate reform and growth incentives that will make U.S. businesses and workers more competitive and will create jobs in the United States. The estimated revenue effects of the provisions comply with the most recent Congressional Budget Office revisions of budget surplus projections.

C. LEGISLATIVE HISTORY

The Committee on Ways and Means marked up the American Jobs Creation Act of 2003 on October 28, 2003, and ordered the bill, as amended, favorably reported by a roll call vote of 24 yeas and 15 nays (with a quorum being present).

II. EXPLANATION OF THE BILL

TITLE I—CORPORATE REFORM AND GROWTH INCENTIVES

A. REDUCTION IN INCOME TAX CORPORATE RATES

1. Reduced corporate income tax rate for domestic production activities income (sec. 1001 of the bill and sec. 11 of the Code)

PRESENT LAW

A corporation's regular income tax liability is determined by applying the following tax rate schedule to its taxable income.

TABLE 1.—MARGINAL FEDERAL CORPORATE INCOME TAX RATES FOR 2003

Taxable income	Income tax rate
$0–$50,000	15 percent of taxable income.
$50,001–$75,000	25 percent of taxable income.

TABLE 1.—MARGINAL FEDERAL CORPORATE INCOME TAX RATES FOR 2003—Continued

Taxable income	Income tax rate
$75,001–$10,000,000	34 percent of taxable income.
Over $10,000,000	35 percent of taxable income.

The benefit of the first two graduated rates described above are phased out by a five-percent surcharge for corporations with taxable income between $100,000 and $335,000. Also, the benefit of the 34-percent rate is phased out by a three-percent surcharge for corporations with taxable income between $15 million and $18,333,333; a corporation with taxable income of $18,333,333 or more effectively is subject to a flat rate of 35 percent.

Under present law, there is no provision that reduces the corporate income tax for taxable income attributable to domestic production activities.

REASONS FOR CHANGE

The Committee believes that creating new jobs is an essential element of economic recovery and expansion, and that tax policies designed to foster job creation also must reverse the recent declines in manufacturing sector employment levels. To accomplish this objective, the Committee believes that Congress should enact tax laws that enhance the ability of domestic businesses, and domestic manufacturing firms in particular, to compete in the global marketplace.

The Committee believes that a reduced tax burden on domestic manufacturers will improve the cash flow of domestic manufacturers and make investments in domestic manufacturing facilities more attractive. Such investment will create and preserve U.S. manufacturing jobs.

EXPLANATION OF PROVISION

In general

The bill provides that the corporate tax rate applicable to qualified production activities income may not exceed 32 percent (34 percent for taxable years beginning before 2007) of the qualified production activities income.

Qualified production activities income

"Qualified production activities income" is the income attributable to domestic production gross receipts, reduced by the sum of: (1) the costs of goods sold that are allocable to such receipts; (2) other deductions, expenses, or losses that are directly allocable to such receipts; and (3) a proper share of other deductions, expenses, and losses that are not directly allocable to such receipts or another class of income.[1]

Domestic production gross receipts

"Domestic production gross receipts" generally are gross receipts of a corporation that are derived from: (1) any sale, exchange or

[1] The Secretary shall prescribe rules for the proper allocation of items of income, deduction, expense, and loss for purposes of determining income attributable to domestic production activities. Where appropriate, such rules shall be similar to and consistent with relevant present-law rules (e.g., secs. 263A and 861).

other disposition, or any lease, rental or license, of qualifying production property that was manufactured, produced, grown or extracted (in whole or in significant part) by the corporation within the United States;[2] (2) any sale, exchange or other disposition, or any lease, rental or license, of qualified film produced by the taxpayer; or (3) construction, engineering or architectural services performed in the United States for construction projects located in the United States. However, domestic production gross receipts do not include any gross receipts of the taxpayer derived from property that is leased, licensed or rented by the taxpayer for use by any related person.[3]

"Qualifying production property" generally is any tangible personal property, computer software, or property described in section 168(f)(4) of the Code. "Qualified film" is any property described in section 168(f)(3) of the Code (other than certain sexually explicit productions) if 50 percent or more of the total compensation relating to the production of such film (other than compensation in the form of residuals and participations) constitutes compensation for services performed in the United States by actors, production personnel, directors, and producers.

Under the bill, an election under section 631(a) made by a corporate taxpayer for a taxable year ending on or before the date of enactment to treat the cutting of timber as a sale or exchange, may be revoked by the taxpayer without the consent of the IRS for any taxable year ending after that date. The prior election (and revocation) is disregarded for purposes of making a subsequent election.

EFFECTIVE DATE

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

2. Reduced corporate income tax rate for small corporations (sec. 1002 of the bill and sec. 11 of the Code)

PRESENT LAW

A corporation's regular income tax liability is determined by applying the following tax rate schedule to its taxable income.

TABLE 1.—MARGINAL FEDERAL CORPORATE INCOME TAX RATES FOR 2003

Taxable income	Income tax rate
$0–$50,000	15 percent of taxable income.

[2] Domestic production gross receipts include gross receipts for a taxpayer derived from any sale, exchange or other disposition of agricultural products with respect to which the taxpayer performs storage, handling or other processing activities (other than transportation activities) within the United States, provided such products are consumed in connection with, or incorporated into, the manufacturing, production, growth or extraction of qualifying production property (whether or not by the taxpayer). Domestic production gross receipts also include gross receipts of a taxpayer derived from any sale, exchange or other disposition of food products with respect to which the taxpayer performs processing activities (in whole or in significant part) within the United States.

[3] It is intended that principles similar to those under the present-law extraterritorial income regime apply for this purpose. See Temp. Treas. Reg. sec. 1.927(a)–1T(f)(2)(i). For example, this exclusion generally does not apply to property leased by the taxpayer to a related person if the property is held for sublease, or is subleased, by the related person to an unrelated person for the ultimate use of such unrelated person. Similarly, the license of computer software to a related person for reproduction and sale, exchange, lease, rental or sublicense to an unrelated person for the ultimate use of such unrelated person is not treated as excluded property by reason of the license to the related person.

TABLE 1.—MARGINAL FEDERAL CORPORATE INCOME TAX RATES FOR 2003—Continued

Taxable income	Income tax rate
$50,001–$75,000	25 percent of taxable income.
$75,001–$10,000,000	34 percent of taxable income.
Over $10,000,000	35 percent of taxable income.

The benefit of the first two graduated rates described above are phased out by a five-percent surcharge for corporations with taxable income between $100,000 and $335,000. Also, benefit of the 34-percent rate is phased out by a three-percent surcharge for corporations with taxable income between $15 million and $18,333,333; a corporation with taxable income of $18,333,333 or more effectively is subject to a flat rate of 35 percent.

REASONS FOR CHANGE

The Committee believes that reducing the tax burden on small and medium sized businesses will enable them to continue to maintain and create new jobs in the United States. A reduced tax burden on smaller businesses simultaneously makes investments by small businesses more attractive and improves the cash flow of such businesses, thus facilitating the financing of investments. New investment by small business is responsible for substantial job creation in the economy and provides the foundation for new industries, new technology, and the future of the U. S. economy.

EXPLANATION OF PROVISION

Under the provision, a corporation's regular income tax liability is determined by applying the following tax rate schedules to its taxable income.

TABLE 2.—MARGINAL FEDERAL CORPORATE INCOME TAX RATES FOR 2012 AND THEREAFTER

Taxable income	Income tax rate
$0–$50,000	15 percent of taxable income.
$50,001–$75,000	25 percent of taxable income.
$75,001–$20,000,000	32 percent of taxable income.
Over $20,000,000	35 percent of taxable income.

The benefit of the graduated rates described above are phased out by a three-percent surcharge for corporations with taxable income between $20 million and $40,341,667; a corporation with taxable income of $40,341,667 or more effectively is subject to a flat rate of 35 percent.

TABLE 3.—MARGINAL FEDERAL CORPORATE INCOME TAX RATES FOR 2007–2008

Taxable income	Income tax rate
$0–$50,000	15 percent of taxable income.
$50,001–$75,000	25 percent of taxable income.
$75,001–$5,000,000	32 percent of taxable income.
$5,000,000–$10,000,000	34 percent of taxable income.
Over $10,000,000	35 percent of taxable income.

The benefit of the first three graduated rates described above are phased out by a five-percent surcharge for corporations with taxable income between $5,000,000 and $7,480,000. Also, the benefit of the 34-percent rate is phased out by a three-percent surcharge for corporations with taxable income between $15 million and $18,333,333; a corporation with taxable income of $18,333,333 or more effectively is subject to a flat rate of 35 percent.

TABLE 4.—MARGINAL FEDERAL CORPORATE INCOME TAX RATES FOR 2007–2008

Taxable income	Income tax rate
$0–$50,000	15 percent of taxable income.
$50,001–$75,000	25 percent of taxable income.
$75,001–$1,000,000	32 percent of taxable income.
$1,000,000–$10,000,000	34 percent of taxable income.
Over $10,000,000	35 percent of taxable income.

The benefit of the first three graduated rates described above are phased out by a five-percent surcharge for corporations with taxable income between $1,000,000 and $1,605,000. Also, the benefit of the 34-percent rate is phased out by a three-percent surcharge for corporations with taxable income between $15 million and $18,333,333; a corporation with taxable income of $18,333,333 or more effectively is subject to a flat rate of 35 percent.

TABLE 5.—MARGINAL FEDERAL CORPORATE INCOME TAX RATES FOR 2004–2006

Taxable income	Income tax rate
$0–$50,000	15 percent of taxable income.
$50,001–$75,000	25 percent of taxable income.
$75,001–$1,000,000	33 percent of taxable income.
$1,000,000–$10,000,000	34 percent of taxable income.
Over $10,000,000	35 percent of taxable income.

The benefit of the first three graduated rates described above are phased out by a five-percent surcharge for corporations with taxable income between $1,000,000 and $1,420,000. Also, the benefit of the 34-percent rate is phased out by a three-percent surcharge for corporations with taxable income between $15 million and $18,333,333; a corporation with taxable income of $18,333,333 or more effectively is subject to a flat rate of 35 percent.

EFFECTIVE DATE

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

B. EXTENSION OF INCREASED SECTION 179 EXPENSING

(Sec. 1011 of the bill and sec. 179 of the Code)

PRESENT LAW

Present law provides that, in lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct such costs. The Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) of 2003[4] increased the amount a taxpayer may deduct, for taxable years beginning in 2003 through 2005, to $100,000 of the cost of qualifying property placed in service for the taxable

[4] Pub. Law No. 108–27, sec. 202(2003).

year.[5] 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. For taxable years beginning after 2002 and before 2006, the $100,000 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 $400,000. The dollar limitations are indexed annually for inflation for taxable years beginning in a calendar year after 2003 and before 2006. The provision also includes off-the-shelf computer software placed in service in a taxable year beginning in 2003 through 2005 as qualifying property.

Prior to the enactment of JGTRRA (and for taxable years beginning in 2006 and thereafter) a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year. 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. 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 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.

Under present law, an expensing election is made under rules prescribed by the Secretary.[6] Applicable Treasury Regulations provide that an expensing election generally is made on the taxpayer's original return for the taxable year to which the election relates.[7]

Prior to the enactment of JGTRRA (and for taxable years beginning in 2006 and thereafter), an expensing election may be revoked only with consent of the Commissioner.[8] JGTRRA permits taxpayers to revoke expensing elections on amended returns without the consent of the Commissioner with respect to a taxable year beginning after 2002 and before 2006.[9]

REASONS FOR CHANGE

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

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

[6] Sec. 179(c)(1).

[7] Treas. Reg. sec. 1.179–5. Under these regulations, 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).

[8] Sec. 179(c)(2).

[9] Id.

depreciation recordkeeping requirements with respect to expensed property. In the Jobs and Growth Tax Relief Reconciliation Act of 2003, Congress acted to increase the value of these benefits and to increase the number of taxpayers eligible for taxable years through 2005. The Committee believes that these changes to section 179 expensing will continue to provide important benefits if extended, and the bill therefore extends these changes for an additional two years.

EXPLANATION OF PROVISION

The provision extends the increased amount that a taxpayer may deduct, and other changes that were made by JGTRRA of 2003, for an additional two years. Thus, the provision provides that the maximum dollar amount that may be deducted under section 179 is $100,000 for property placed in service in taxable years beginning before 2008 ($25,000 for taxable years beginning in 2008 and thereafter). In addition, the $400,000 amount applies for property placed in service in taxable years beginning before 2008 ($200,000 for taxable years beginning in 2008 and thereafter). The provision extends, through 2007 (from 2005), the indexing for inflation of both the maximum dollar that may be deducted and the $400,000 amount. The provision also includes off-the-shelf computer software placed in service in taxable years beginning before 2008 as qualifying property. The provision permits taxpayers to revoke expensing elections on amended returns without the consent of the Commissioner with respect to a taxable year beginning before 2008. The Committee expects that the Secretary will prescribe regulations to permit a taxpayer to make an expensing election on an amended return without the consent of the Commissioner.

EFFECTIVE DATE

The provision is effective on the date of enactment.

C. Recovery Period for Depreciation of Certain Leasehold Improvements and Restaurant Property

(Sec. 1021 of the bill and sec. 168 of the Code)

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"), which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property (sec. 168). The cost of nonresidential real property is recovered using the straight-line method of depreciation and a recovery period of 39 years. Nonresidential real property is subject to the mid-month placed-in-service convention. Under the mid-month convention, the depreciation allowance for the first year property is placed in service is based on the number of months the property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month.

Depreciation of leasehold improvements

Depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease (sec. 168(i)(8)).[10] This rule applies regardless of whether the lessor or the lessee places the leasehold improvements in service.[11] If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement is depreciated using the straight-line method over a 39–year recovery period, beginning in the month the addition or improvement was placed in service (secs. 168(b)(3), (c), (d)(2), and (i)(6)).[12]

Qualified leasehold improvement property

The Job Creation and Worker Assistance Act of 2002[13] as amended by the Jobs and Growth Tax Relief Reconciliation Act of 2003[14] generally provides an additional first-year depreciation deduction equal to either 30 percent or 50 percent of the adjusted basis of qualified property placed in service before January 1, 2005. Qualified property includes qualified leasehold improvement property. For this purpose, qualified leasehold improvement property is any improvement to an interior portion of a building that is nonresidential real property, provided certain requirements are met. The improvement must be made under or pursuant to a lease either by the lessee (or sublessee), or by the lessor, of that portion of the building to be occupied exclusively by the lessee (or sublessee). The improvement must be placed in service more than three years after the date the building was first placed in service. Qualified leasehold improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building.

Treatment of dispositions of leasehold improvements

A lessor of leased property that disposes of a leasehold improvement which was made by the lessor for the lessee of the property may take the adjusted basis of the improvement into account for purposes of determining gain or loss if the improvement is irrevocably disposed of or abandoned by the lessor at the termination of the lease. This rule conforms the treatment of lessors and lessees

[10] The Tax Reform Act of 1986 modified the Accelerated Cost Recovery System ("ACRS") to institute MACRS. Prior to the adoption of ACRS by the Economic Recovery Tax Act of 1981, taxpayers were allowed to depreciate the various components of a building as separate assets with separate useful lives. The use of component depreciation was repealed upon the adoption of ACRS. The Tax Reform Act of 1986 also denied the use of component depreciation under MACRS.

[11] Former sections 168(f)(6) and 178 provided that, in certain circumstances, a lessee could recover the cost of leasehold improvements made over the remaining term of the lease. The Tax Reform Act of 1986 repealed these provisions.

[12] If the improvement is characterized as tangible personal property, ACRS or MACRS depreciation is calculated using the shorter recovery periods and accelerated methods applicable to such property. The determination of whether improvements are characterized as tangible personal property or as nonresidential real property often depends on whether or not the improvements constitute a "structural component" of a building (as defined by Treas. Reg. sec. 1.48–1(c)(1)). See, *e.g., Metro National Corp* v. *Commissioner.,* 52 TCM (CCH) 1440 (1987); *King Radio Corp Inc* v. *U.S.*, 486 F.2d 1091 (105h Cir. 1973); *Mallinekrodt, Inc.* v. *Commissioner*, 778 F.2d 402 (8th Cir. 1985)(with respect to various leasehold improvements).

[13] Pub. Law No. 107–147, sec 101 (2002).

[14] Pub. Law No. 198–27, sec. 201 (2003).

with respect to leasehold improvements disposed of at the end of a term of lease.

REASONS FOR CHANGE

The Committee believes that taxpayers should not be required to recover the costs of investments beyond the useful life of the investment. The present law 39-year recovery period for leasehold improvements extends well beyond the useful life of such investments. Although lease terms differ, the Committee believes that lease terms for commercial real estate typically are shorter than the present-law 39-year recovery period. In the interests of simplicity and administrability, a uniform period for recovery of leasehold improvements is desirable. The Committee bill therefore shortens the recovery period for leasehold improvements to a more realistic 15 years.

The Committee also believes that unlike other commercial buildings, restaurant buildings generally are more specialized structures. Restaurants also experience considerably more traffic, and remain open longer than most retail properties. This daily assault causes rapid deterioration of restaurant properties, and forces restaurateurs to constantly repair and upgrade their facilities. As such, restaurant facilities have a much shorter life span than other commercial establishments. The Committee bill reduces the 39-year recovery period for improvements made to restaurant buildings and more accurately reflects the true economic life of the properties by reducing the recovery period to 15 years.

EXPLANATION OF PROVISION

The provision provides a statutory 15-year recovery period for qualified leasehold improvement property placed in service before January 1, 2006.[15] The provision requires that qualified leasehold improvement property be recovered using the straight-line method.

Qualified leasehold improvement property is defined as under present law for purposes of the additional first-year depreciation deduction (sec. 168(k)), with the following modification. If a lessor makes an improvement that qualifies as qualified leasehold improvement property such improvement shall not qualify as qualified leasehold improvement property to any subsequent owner of such improvement. An exception to the rule applies in the case of death and certain transfers of property that qualify for non-recognition treatment.

The provision also provides a statutory 15-year recovery period for qualified restaurant property placed in service before January 1, 2006.[16] For purposes of the provision, qualified restaurant property means any improvement to a building if such building has been in service more than three years and more than 50 percent of the building's square footage is devoted to the preparation of, and seating for, on-premises consumption of prepared meals. The provision requires that qualified restaurant property be recovered using the straight-line method.

[15] Qualified leasehold improvement property continues to be eligible for the additional first-year depreciation deduction under sec. 168(k).

[16] Qualified restaurant property would become eligible for the additional first-year depreciation deduction under sec. 168(k) by virtue of the assigned 20-year recovery period.

EFFECTIVE DATE

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

D. Alternative Minimum Tax Relief

1. Net operating losses and foreign tax credit; expansion of small corporation exemption (secs. 1031–1032 of the bill and secs. 55–59 of the Code)

PRESENT LAW

In general

Under present law, taxpayers are subject to an alternative minimum tax ("AMT"), which is payable in addition to all other tax liabilities. The tax is imposed on the amount by which the tentative minimum tax exceeds the regular tax liability. In the case of corporations, the tentative minimum tax is computed at a flat rate of 20 percent on alternative minimum taxable income ("AMTI") in excess of an exemption amount that phases out.[17] AMTI is the taxpayer's taxable income increased for certain tax preferences and adjusted by determining the tax treatment of certain items in a manner that limits the tax benefits resulting from the regular tax treatment of such items.

Net operating loss

Taxpayers generally may use the net operating loss deduction to offset 90 percent of AMTI (determined without regard to the net operating loss deduction). A special rule allows a net operating loss carryback from, or carryover to, a taxable year ending during 2001 or 2002 to offset 100 percent of AMTI.

Foreign tax credit

Taxpayers are permitted to reduce their AMT liability by an AMT foreign tax credit. The AMT foreign tax credit for a taxable year is determined under principles similar to those used in computing the regular tax foreign tax credit, except that (1) the numerator of the AMT foreign tax credit limitation fraction is foreign source AMTI and (2) the denominator of that fraction is total AMTI. Taxpayers may elect to use as their AMT foreign tax credit limitation fraction the ratio of foreign source regular taxable income to total AMTI.

The AMT foreign tax credit for any taxable year generally may not offset a taxpayer's entire pre-credit AMT. Rather, the AMT foreign tax credit is limited to 90 percent of AMT computed without any AMT net operating loss deduction and the AMT foreign tax credit. For example, assume that a corporation has $10 million of AMTI, has no AMT net operating loss deduction, and has no regular tax liability. In the absence of the AMT foreign tax credit, the corporation's tax liability would be $2 million. Accordingly, the AMT foreign tax credit cannot be applied to reduce the taxpayer's tax liability below $200,000. Any unused AMT foreign tax credit may be carried back two years and carried forward five years for

[17] In the case of individuals, the rates are 26 and 28 percent.

use against AMT in those years under the principles of the foreign tax credit carryback and carryover rules set forth in section 904(c).

Small corporation exemption

Corporations with average gross receipts of less than $7.5 million for the prior three taxable years are exempt from the corporate alternative minimum tax. The $7.5 million threshold is reduced to $5 million for the corporation's first three-taxable year period.

REASONS FOR CHANGE

The Committee believes that the alternative minimum tax is merely a prepayment of tax. The corporate alternative minimum tax requires businesses to prepay their taxes when they can least afford it, during a business downturn. The Committee believes that increasing the gross receipts cap for companies exempt from corporate AMT from $7.5 million of gross receipts to $20 million of gross receipts will relieve many taxpayers of both the administrative burden of calculating their income tax liability under two separate tax systems and the financial burden of having to prepay their tax when they can least afford it. The Committee also believes that taxpayers should be permitted to more fully utilize net operating losses and foreign tax credits in computing the alternative minimum tax than is permitted under current law.

EXPLANATION OF PROVISION

The provision phases-out the 90-percent limitation on the use of the net operating loss deduction in computing AMTI. The limitation is increased to 92 percent for taxable years beginning in 2005, 2006 and 2007; 94 percent for taxable years beginning in 2008 and 2009; 96 percent for taxable years beginning in 2010; 98 percent for taxable years beginning in 2011; and 100 percent for taxable years beginning in and after 2012.

The provision repeals the 90-percent limitation on the utilization of the AMT foreign tax credit.

The provision increases the amount of average gross receipts that an exempt corporation may receive from $7.5 million to $20 million.

EFFECTIVE DATE

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

2. Income averaging for farmers not to increase alternative minimum tax (sec. 1033 of the bill and sec. 55 of the Code)

PRESENT LAW

An individual engaged in a farming business (as defined in section 263A(e)(4)) may elect to compute his or her current year income tax liability by averaging, over the prior three-year period, all or portion of his or her taxable income from the trade or business of farming.[18] The averaging election is not available in computing the tentative minimum tax. As a result, some farmers may become

[18] Sec. 1301.

liable for the alternative minimum tax as a result of the averaging election.

REASONS FOR CHANGE

The Committee believes that farmer income averaging should be coordinated with the alternative minimum tax so that a farmer's alternative minimum tax liability is not increased because he or she elects income averaging.

EXPLANATION OF PROVISION

The bill modifies the alternative minimum tax to allow farmers the full benefit of income averaging. Under the bill, a farmer owes alternative minimum tax only to the extent he or she would owe alternative minimum tax had averaging not been elected. This result is achieved by excluding the impact of the election to average farm income from the calculation of regular tax liability in computing the alternative minimum tax.

EFFECTIVE DATE

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

E. Provisions Relating to S Corporation Reform and Simplification

(Secs. 1041–1051 of the bill and secs. 1361–1379 sec. and 4975 of the Code)

OVERVIEW

In general, an S corporation is not subject to corporate-level income tax on its items of income and loss. Instead, an S corporation passes through its items of income and loss to its shareholders. The shareholders take into account separately their shares of these items on their individual income tax returns. To prevent double taxation of these items when the stock is later disposed of, each shareholder's basis in the stock of the S corporation is increased by the amount included in income (including tax-exempt income) and is decreased by the amount of any losses (including nondeductible losses) taken into account. A shareholder's loss may be deducted only to the extent of his or her basis in the stock or debt of the corporation. To the extent a loss is not allowed due to this limitation, the loss generally is carried forward with respect to the shareholder.

REASONS FOR CHANGE

The bill contains a number of general provisions relating to S corporations. The Committee adopted these provisions that modernize the S corporation rules and eliminate undue restrictions on S corporations in order to expand the application of the S corporation provisions so that more corporations and their shareholders will be able to enjoy the benefits of subchapter S status.

The Committee is aware of obstacles that have prevented banks from electing subchapter S status.[19] The bill contains provisions that apply specifically to banks in order to remove these obstacles and make S corporation status more readily available to banks.

The bill also revises the prohibited transaction rules applicable to employee stock ownership plans ("ESOPs") maintained by S corporations in order to expand the ability to use distributions made with respect to S corporation stock held by an ESOP to repay a loan used to purchase the stock, subject to the same conditions that apply to C corporation dividends used to repay such a loan.

1. Shareholders of an S corporation

PRESENT LAW

In general

A small business corporation may elect to be an S corporation with the consent of all its shareholders, and may terminate its election with the consent of shareholders holding more than 50 percent of the stock. A "small business corporation" is defined as a domestic corporation which is not an ineligible corporation and which has (1) no more than 75 shareholders, all of whom are individuals (and certain trusts, estates, charities, and qualified retirement plans)[20] who are citizens or residents of the United States, and (2) only one class of stock. For purposes of the 75–shareholder limitation, a husband and wife are treated as one shareholder. An "ineligible corporation" means a corporation that is a financial institution using the reserve method of accounting for bad debts, an insurance company, a corporation electing the benefits of the Puerto Rico and possessions tax credit, or a Domestic International Sales Corporation ("DISC") or former DISC.

Individual retirement accounts

An individual retirement account ("IRA") is a trust or account established for the exclusive benefit of an individual and his or her beneficiaries. There are two general types of IRAs: traditional IRAs, to which both deductible and nondeductible contributions may be made, and Roth IRAs, contributions to which are not deductible. Amounts held in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal is a return of nondeductible contributions). Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income; distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings. A qualified distribution is a distribution that (1) is made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) is made after attainment of age 59½ on account of death

[19] *See* GAO/GGD–00–159, Banking Taxation, Implications of Proposed Revisions Governing S–Corporations on Community Banks (June 23, 2000), for discussion of issues relating to community banks electing subchapter S.

[20] If a qualified retirement plan (other than an employee stock ownership plan) or a charity holds stock in an S corporation, the interest held is treated an an interest in an unrelated trade or business, and the plan or charity's share of the S corporation's items of income, loss, or deduction, and gain or loss on the disposition of the S corporation stock, are taken into account in computing unrelated business taxable income.

or disability, or is made for first-time homebuyer expenses of up to $10,000.

Under present law, an IRA cannot be a shareholder of an S corporation.

Certain transactions are prohibited between an IRA and the individual for whose benefit the IRA is established, including a sale of property by the IRA to the individual. If a prohibited transaction occurs between an IRA and the IRA beneficiary, the account ceases to be an IRA, and an amount equal to the fair market value of the assets held in the IRA is deemed distributed to the beneficiary.

EXPLANATION OF PROVISION

In general

The bill provides that all family members can elect to be treated as one shareholder for purposes of determining the number of shareholders in the corporation. A family is defined as the lineal descendants of a common ancestor (and their spouses). The common ancestor cannot be more than three 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). Except as provided by Treasury regulations, the election may be made by any family member and the election remains in effect until terminated.

The bill increases the maximum number of eligible shareholders from 75 to 100.

Individual retirement accounts

The bill allows an IRA (including a Roth IRA) to be a shareholder of a bank that is an S corporation, but only to the extent of bank stock held by the IRA on the date of enactment of the provision.[21]

The bill also provides an exemption from prohibited transaction treatment for the sale by an IRA to the IRA beneficiary of bank stock held by the IRA on the date of enactment of the provision. Under the bill, a sale is not a prohibited transaction if: (1) the sale is pursuant to an S corporation election by the bank; (2) the sale is for fair market value (as established by an independent appraiser) and is on terms at least as favorable to the IRA as the terms would be on a sale to an unrelated party; (3) the IRA incurs no commissions, costs, or other expenses in connection with the sale; and (4) the stock is sold in a single transaction for cash not later than 120 days after the S corporation election is made.

EFFECTIVE DATE

The provisions generally apply to taxable years beginning after December 31, 2003. The provision relating to IRAs takes effect on the date of enactment of the bill.

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[21] Under the bill, the present-law rules treating S corporation stock held by a qualified retirement plan (other than an employee stock ownership plan) or a charity as an interest in an unrelated trade or business apply to an IRA holding S corporation stock of a bank.

2. Treatment of S corporation shareholders

(a) Electing small business trusts

PRESENT LAW

An electing small business trust ("ESBT") holding stock in an S corporation is taxed at the maximum individual tax rate on its ratable share of items of income, deduction, gain, or loss passing through from the S corporation. An ESBT generally is an electing trust all of whose beneficiaries are eligible S corporation shareholders. For purposes of determining the maximum number of shareholders, each person who is entitled to receive a distribution from the trust ("potential current beneficiary") is treated as a shareholder during the period the person may receive a distribution from the trust.

An ESBT has 60 days to dispose of the S corporation stock after an ineligible shareholder becomes a potential current beneficiary to avoid disqualification.

EXPLANATION OF PROVISION

Under the bill, powers of appointment to the extent not exercised are disregarded in determining the potential current beneficiaries of an electing small business trust.

The bill increases the period during which an ESBT can dispose of S corporation stock after an ineligible shareholder becomes a potential current beneficiary from 60 days to one year.

EFFECTIVE DATE

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

(b) Qualified subchapter S trusts

PRESENT LAW

Under present law, the share of income of an S corporation whose stock is held by a qualified subchapter S trust ("QSST"), with respect to which the beneficiary makes an election, is taxed to the beneficiary. However, the trust, and not the beneficiary, is treated as the owner of the S corporation stock for purposes of determining the tax consequences of the disposition of the S corporation stock by the trust. A QSST generally is a trust with one individual income beneficiary for the life of the beneficiary.

EXPLANATION OF PROVISION

Under the bill, the beneficiary of a qualified subchapter S trust is generally allowed to deduct suspended losses under the at-risk rules and the passive loss rules when the trust disposes of the S corporation stock.

EFFECTIVE DATE

The provision applies to transfers made after December 31, 2003.

(c) Transfers of losses incident to divorce, etc.

PRESENT LAW

Under present law, any loss or deduction that is not allowed to a shareholder of an S corporation, because the loss exceeds the shareholder's basis in stock and debt of the corporation, is treated as incurred by the corporation with respect to that shareholder in the subsequent taxable year.

EXPLANATION OF PROVISION

Under the bill, if a shareholder's stock in an S corporation is transferred to a spouse, or to a former spouse incident to a divorce, any suspended loss or deduction with respect to that stock is treated as incurred by the corporation with respect to the transferee in the subsequent taxable year.

EFFECTIVE DATE

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

3. Provisions relating to banks

(a) Exclusion of investment securities income from passive investment income test for bank S corporations

PRESENT LAW

An S corporation is subject to corporate-level tax, at the highest corporate tax rate, on its excess net passive income if the corporation has (1) accumulated 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 accumulated earnings and profits at the close of each of three consecutive taxable years and has gross receipts for each of those years more than 25 percent of which are passive investment income.

Excess net passive income is the net passive income for a taxable year multiplied by a fraction, the numerator of which is the amount of passive investment income in excess of 25 percent of gross receipts and the denominator of which is the passive investment income for the year. Net passive income is defined as passive investment income reduced by the allowable deductions that are directly connected with the production of that income. 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 commodities dealer.[22]

[22] IRS Notice 97–5, 1997–1 C.B. 352, sets forth guidance relating to passive investment income on banking assets.

EXPLANATION OF PROVISION

The bill provides that, in the case of a bank (as defined in section 581), a bank holding company (as defined in section 2(a) of the Bank Holding Company Act of 1956), or a financial holding company (as defined in section 2(p) of that Act), interest income and dividends on assets required to be held by the bank or holding company are not treated as passive investment income for purposes of applying the excess net passive income rules.

EFFECTIVE DATE

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

(b) Treatment of bank director shares

PRESENT LAW

An S corporation may have no more than 75 shareholders and may have only one outstanding class of stock.[23]

An S corporation has one class of stock if all outstanding shares of stock confer identical rights to distribution and liquidation proceeds. Differences in voting rights are disregarded.[24]

National banking law requires that a director of a national bank own stock in the bank and that the bank have at least five directors.[25] A number of states have similar requirements for state-chartered banks. Apparently, it is common for bank directors to enter into agreements with the bank under which the director will sell the stock back to the bank upon ceasing to be a director at the price paid for the stock.[26]

EXPLANATION OF PROVISION

Under the bill, restricted bank director stock shall not be taken into account as outstanding stock in applying the provisions of subchapter S. Thus, for example, the stock will not be treated as a second class of stock; the holder of the stock will not be treated as a shareholder by reason of the ownership of the stock; and the stock will be disregarded in allocating items of income, loss, etc. among the shareholders.

Restricted bank director stock means shares in a bank (as defined in section 581), a bank holding company (within the meaning of section 2(a) of the Bank Holding Company Act of 1956), or a financial holding company (as defined in section 2(p) of that Act) held by an individual solely by reason of status as a director of the bank or company and which are subject to an agreement with the bank or holding company (or corporation in control of the bank or company) pursuant to which the holder agrees to sell the stock

[23] Another provision of the bill increases the maximum number of shareholders to 100.

[24] Treas. Reg. sec. 1.1361–1(1). The regulations provide that buy-sell and redemption agreements are disregarded in determining whether a corporation's outstanding shares confer identical distribution and liquidation rights unless (1) a principal purpose of the agreement is to circumvent the one class of stock requirement and (2) the agreement establishes a purchase price that, at the time the agreement is entered into, is significantly in excess of or below the fair market value of the stock.

[25] 12 U.S.C. secs. 71–72.

[26] For example, see Private Letter Ruling 200217048 (January 24, 2002) describing such an agreement and holding that it creates a second class of stock.

back upon ceasing to be a director at the same price the individual acquired the stock.

Distributions (not in exchange for the stock) with respect to the restricted shares are includible in the gross income of the director and deductible by the corporation.

EFFECTIVE DATE

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

4. Qualified subchapter S subsidiaries

(a) Relief from inadvertently invalid qualified subchapter S subsidiary elections and terminations

PRESENT LAW

Under present law, inadvertent invalid subchapter S elections and terminations may be waived.

EXPLANATION OF PROVISION

The bill allows inadvertent invalid qualified subchapter S subsidiary elections and terminations to be waived by the IRS.

EFFECTIVE DATE

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

(b) Information returns for qualified subchapter S subsidiaries

PRESENT LAW

Under present law, a corporation all of whose stock is held by an S corporation is treated as a qualified subchapter S subsidiary if the S corporation so elects. 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.

EXPLANATION OF PROVISION

The bill provides authority to the Secretary to provide guidance regarding information returns of qualified subchapter S subsidiaries.

EFFECTIVE DATE

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

5. S corporation distributions to an employee stock ownership plan

PRESENT LAW

An employee stock ownership plan (an "ESOP") is a defined contribution plan that is designated as an ESOP and is designed to invest primarily in qualifying employer securities. For purposes of ESOP investments, a "qualifying employer security" is defined as: (1) publicly traded common stock of the employer or a member of the same controlled group; (2) if there is no such publicly traded common stock, common stock of the employer (or member of the same controlled group) that has both voting power and dividend rights at least as great as any other class of common stock; or (3) noncallable preferred stock that is convertible into common stock described in (1) or (2) and that meets certain requirements. In some cases, an employer may design a class of preferred stock that meets these requirements and that is held only by the ESOP. Special rules apply to ESOPs that do not apply to other types of qualified retirement plans, including a special exemption from the prohibited transaction rules.

Certain transactions between an employee benefit plan and a disqualified person, including the employer maintaining the plan, are prohibited transactions that result in the imposition of an excise tax.[27] Prohibited transactions include, among other transactions, (1) the sale, exchange or leasing of property, (2) the lending of money or other extension of credit, and (3) the transfer to, or use by or for the benefit of, the income or assets of the plan. However, certain transactions are exempt from prohibited transaction treatment, including certain loans to enable an ESOP to purchase qualifying employer securities.[28] In such a case, the employer securities purchased with the loan proceeds are generally pledged as security for the loan. Contributions to the ESOP and dividends paid on employer stock held by the ESOP are used to repay the loan. The employer stock is held in a suspense account and released for allocation to participants' accounts as the loan is repaid.

A loan to an ESOP is exempt from prohibited transaction treatment if the loan is primarily for the benefit of the participants and their beneficiaries, the loan is at a reasonable rate of interest, and the collateral given to a disqualified person consists of only qualifying employer securities. No person entitled to payments under the loan can have the right to any assets of the ESOP other than (1) collateral given for the loan, (2) contributions made to the ESOP to meet its obligations on the loan, and (3) earnings attributable to the collateral and the investment of contributions described in (2).[29] In addition, the payments made on the loan by the ESOP during a plan year cannot exceed the sum of those contributions and earnings during the current and prior years, less loan payments made in prior years.

An ESOP of a C corporation is not treated as violating the qualification requirements of the Code or as engaging in a prohibited transaction merely because, in accordance with plan provisions, a dividend paid with respect to qualifying employer securities held by the ESOP is used to make payments on a loan (including payments of interest as well as principal) that was used to acquire the employer securities (whether or not allocated to participants).[30] In the case of a dividend paid with respect to any employer security that is allocated to a participant, this relief does not apply unless the plan provides that employer securities with a fair market value of not less than the amount of the dividend is allocated to the partici-

[27] Sec. 4975.

[28] Sec. 4975(d)(3). An ESOP that borrows money to purchase employer stock is referred to as a "leveraged" ESOP.

[29] Treas. reg. sec. 54.4975–7(b)(5).

[30] Sec. 404(k)(5)(B).

pant for the year which the dividend would have been allocated to the participant.[31]

EXPLANATION OF PROVISION

Under the provision, an ESOP maintained by an S corporation is not treated as violating the qualification requirements of the Code or as engaging in a prohibited transaction merely because, in accordance with plan provisions, a distribution made with respect to S corporation stock that constitutes qualifying employer securities held by the ESOP is used to repay a loan that was used to acquire the securities (whether or not allocated to participants). This relief does not apply in the case of a distribution with respect to S corporation stock that is allocated to a participant unless the plan provides that stock with a fair market value of not less than the amount of such distribution is allocated to the participant for the year which the distribution would have been allocated to the participant.

EFFECTIVE DATE

The provision is effective for distributions made with respect to S corporation stock after December 31, 2003.

F. Employee Benefits

1. Treatment of nonqualified deferred compensation plans (sec. 1061 of the bill and new sec. 409A and sec. 6051 of the Code)

PRESENT LAW

In general

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,[32] the provisions of section 83 relating generally to transfers of property in connection with the performance of services, and provisions relating specifically to nonexempt employee trusts (sec. 402(b)) and nonqualified annuities (sec. 403(c)).

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

Nonqualified deferred compensation is generally subject to social security and Medicare taxes when the compensation 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

[31] Sec. 404(k)(2)(B).

[32] 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.

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.[33] 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 if 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.[34] Income is constructively received when it is credited to an individual's account, set apart, or otherwise made available so that it may 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 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

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

[34] Treas. Reg. secs. 1.451–1 and 1.451–2.

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.[35] 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.[36] Revenue Procedure 92–64 provides a safe harbor for taxpayers who adopt and maintain grantor trusts in connection with unfunded deferred compensation arrangements. The model trust language requires that the trust provide that all assets of the trust are subject to the claims of the general creditors of the company in the event of the company's insolvency or bankruptcy.

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

REASONS FOR CHANGE

The Committee is aware of the popular use of deferred compensation arrangements by executives to defer current taxation of substantial amounts of income. The Committee believes that many nonqualified deferred compensation arrangements have developed which allow improper deferral of income. Executives often use arrangements that allow deferral of income, but also provide security of future payment and control over amounts deferred. For example, nonqualified deferred compensation arrangements often contain provisions that allow participants to receive distributions upon request, subject to forfeiture of a minimal amount (i.e., a "haircut" provision).

Since the concept of a rabbi trust was developed, techniques have developed that attempt to protect the assets from creditors despite the terms of the trust. For example, the trust or fund may be located in a foreign jurisdiction, making it difficult or impossible for creditors to reach the assets.

While the general tax principles governing deferred compensation are well established, the determination whether a particular arrangement effectively allows deferral of income is generally made on a facts and circumstances basis. There is limited specific guidance with respect to common deferral arrangements. The Committee believes that it is appropriate to provide specific rules regarding whether deferral of income inclusion should be permitted.

The Committee believes that, consistent with the intent of current law, certain arrangements that allow participants inappropriate levels of control or access to amounts deferred should not result in deferral of income inclusion. The Committee also believes that certain arrangements, such as offshore trusts, which effec-

[35] 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).

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

tively protect assets from creditors, should be treated as funded and not result in deferral of income inclusion.[37]

EXPLANATION OF PROVISION

Under the provision, all amounts deferred under a nonqualified deferred compensation plan[38] for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture[39] and not previously included in gross income, unless certain requirements are satisfied. If the requirements of the provision are not satisfied, in addition to current income inclusion, interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture. Actual or notional earnings on amounts deferred are also subject to the provision.

Under the provision, distributions from a nonqualified deferred compensation plan may be allowed only upon separation from service (as determined by the Secretary), disability, death, a specified time (or pursuant to a fixed schedule), change in control in a corporation (to the extent provided by the Secretary), or occurrence of an unforeseeable emergency. A nonqualified deferred compensation plan may not allow distributions other than upon the permissible distribution events and may not permit acceleration of a distribution, except as provided in regulations by the Secretary.

In the case of a specified employee, distributions upon separation from service may not be made earlier than six months after the date of the separation from service. Specified employees are key employees[40] of publicly-traded corporations.

Disability is defined as under the Social Security Act. Under such definition, an individual is considered to be disabled if he or she 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. In determining if a participant is disabled, a determination letter from the Social Security Administration is not required. It is intended that a nonqualified deferred compensation plan provide that the determination of whether a participant is disabled must be based on the Social Security Administration statutory standard.

Amounts payable at a specified time or pursuant to a fixed schedule must be specified under the plan at the time of deferral.

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[37] The staff of the Joint Committee on Taxation made recommendations similar to the new provision in the report on their investigation of Enron Corporation, which detailed how executives deferred millions of dollars in Federal income taxes through nonqualified deferred compensation arrangements. See Joint Committee on Taxation, "Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations" (JCS–3–03), February 2003.

[38] A plan includes an agreement or arrangement, including an agreement or arrangement that includes one person.

[39] As under section 83, the rights of a person to compensation are subject to a substantial risk of forfeiture if the person's rights to such compensation are conditioned upon the performance of substantial services by any individual.

[40] Key employees are defined in section 416(i) and generally include officers having annual compensation greater than $130,000 (adjusted for inflation and limited to 50 employees), five percent owners, and one percent owners having annual compensation from the employer greater than $150,000.

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

Distributions upon a change in the ownership or effective control of a corporation, or in the ownership of a substantial portion of the assets of a corporation, may only be made to the extent provided by the Secretary. It is intended that the Secretary use a similar, but more restrictive, definition of change in control as is used for purposes of the golden parachute provisions of section 280G consistent with the purposes of the provision. The provision requires the Secretary to issue guidance defining change of control within 90 days after the date of enactment.

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

As previously discussed, except as provided in regulations by the Secretary, no accelerations of distributions may be allowed. For example, changes in the form of a distribution from an annuity to a lump sum are not permitted. The provision provides the Secretary authority to provide, through regulations, limited exceptions to the general rule that no accelerations can be permitted. It is intended that exceptions be provided only in limited cases where the accelerated distribution is required for reasons beyond the control of the participant. For example, it is anticipated that an exception could be provided in order to comply with Federal conflict of interest requirements or court-approved settlements.

The provision requires that the plan must provide that compensation for services performed during a taxable year may be deferred at the participant's election only if the election to defer is made during the preceding taxable year, or at such other time as provided in Treasury regulations. In the first year that an employee becomes eligible for participation in a nonqualified deferred compensation plan, the election may be made within 30 days after the date that the employee is initially eligible.

Under the provision, a plan may allow changes in the time and form of distributions subject to certain requirements. A nonqualified deferred compensation plan may allow a subsequent election to delay the timing or form of distributions only if: (1) the plan requires that such election cannot be effective for at least 12 months after the date on which the election is made; (2) except in the case of elections relating to distributions on account of death, disability or unforeseeable emergency, the plan requires that the additional deferral with respect to which such election is made is for a period of not less than five years from the date such payment would otherwise have been made; and (3) the plan requires that an election related to a distribution to be made upon a specified time may not be made less than 12 months prior to the date of the first scheduled payment. It is expected that the Secretary shall issue guidance regarding to what extent elections to change a steam of payments are permissible.

If impermissible distributions or elections are made, or if the nonqualified deferred compensation plan allows impermissible distributions or elections, all amounts deferred under the plan (including amounts deferred in prior years) are currently includible in income to the extent not subject to a substantial risk of forfeiture and not previously included in income. In addition, interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture.

Under the provision, in the case of assets held in a trust or set aside (directly or indirectly) in another arrangement, as determined by the Secretary, for purposes of paying nonqualified deferred compensation, such assets are treated as property transferred in connection with the performance of services under section 83 at the time set aside or transferred outside of the United States (whether or not such assets are available to satisfy the claims of general creditors). Any increases in the value of, or any earnings with respect to, such assets are treated as additional transfers of property. Interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the amounts been includible in income for the taxable year such assets were first set aside for purposes of nonqualified deferred compensation. The Secretary has authority to exempt arrangements from the provision if the arrangements do not result in an improper deferral of U.S. tax and will not result in assets being effectively beyond the reach of creditors.

Under the provision, a transfer of property in connection with the performance of services under section 83 also occurs if a nonqualified deferred compensation plan provides that, upon a change in the employer's financial health, assets will be restricted to the payment of nonqualified deferred compensation. The transfer of property occurs as of the earlier of when the assets are so restricted or when the plan provides that assets will be restricted. Any increases in the value of, or any earnings with respect to, such assets are treated as additional transfers of property. Interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the amounts been includible in income for the taxable year such assets were first set aside for purposes of nonqualified deferred compensation.

A nonqualified deferred compensation plan is any plan that provides for the deferral of compensation other than a qualified employer plan or any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. A qualified employer plan means a qualified retirement plan, tax-deferred annuity, simplified employee pension, and SIMPLE.[41] A governmental eligible deferred compensation plan (sec. 457) is also a qualified employer plan under the provision.

Interest imposed under the provision is treated as interest on an underpayment of tax. Income (whether actual or notional) attributable to nonqualified deferred compensation is treated as additional deferred compensation and is subject to the provision. The provision is not intended to prevent the inclusion of amounts in gross income under any provision or rule of law earlier than the time provided in the provision. Any amount included in gross income under the provision shall not be required to be included in gross income under any provision of law later than the time provided in the provision. The provision does not affect the rules regarding the timing of an employer's deduction for nonqualified deferred compensation.

The provision requires annual reporting to the Internal Revenue Service of amounts deferred. Such amounts are required to be reported on an individual's Form W–2 for the year deferred even if the amount is not currently includible in income for that taxable year. Under the provision, the Secretary is authorized, through regulations, to establish a minimum amount of deferrals below which the reporting requirement does not apply. The Secretary may also provide that the reporting requirement does not apply with respect to amounts of deferrals that are not reasonably ascertainable. It is intended that the exception for amounts not reasonably ascertainable only apply to nonaccount balance plans and that amounts be required to be reported when they first become reasonably ascertainable.[42]

The provision provides the Secretary authority to prescribe regulations as are necessary to carry out the purposes of provision, including regulations: (1) providing for the determination of amounts of deferral in the case of defined benefit plans; (2) relating to changes in the ownership and control of a corporation or assets of a corporation; (3) exempting from the provisions providing for transfers of property arrangements that will not result in an improper deferral of U.S. tax and will not result in assets being effectively beyond the reach of creditors; (4) defining financial health; and (5) disregarding a substantial risk of forfeiture.

It is intended that substantial risk of forfeitures may not be used to manipulate the timing of income inclusion. It is intended that substantial risks of forfeiture should be disregarded in cases in which they are illusory or are principally used to postpone the timing of income inclusion. For example, if an executive is effectively able to control the acceleration of the lapse of a substantial risk of forfeiture, such risk of forfeiture should be disregarded and income inclusion should not be postponed on account of such restriction.

EFFECTIVE DATE

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

The provision does not apply to amounts deferred in a taxable year beginning after December 31, 2003, and before January 1,

[41] A qualified employer plan also includes a section 501(c)(18) trust.

[42] It is intended that the exception be similar to that under Treas. Regs. sec. 31.3121(v)(2)–1(e)(4).

2005, pursuant to an irrevocable election or binding arrangement made before October 24, 2003. Amounts deferred in taxable years beginning after December 31, 2004, even if pursuant to an election made before October 24, 2003, are subject to the provision. Earnings on amounts deferred before the effective date are subject to the provision to the extent that such amounts deferred are subject to the provision.

No later than 90 days after the date of enactment, the Secretary shall issue guidance providing a limited period of time during which an individual participating in a nonqualified deferred compensation plan adopted on or before December 31, 2003, may, without violating the requirements of the provision, terminate participation or cancel an outstanding deferral election with regard to amounts earned after December 31, 2003, if such amounts are includible in income as earned.

Existing nonqualified deferred compensation plans will have to be amended to comply with the modifications made by this provision. It is the intent of the Committee that, immediately following the date of enactment, the Secretary shall issue guidance providing that employers shall have a limited period of time to amend the terms of existing plans relating to amounts deferred pursuant to deferral elections made after October 23, 2003, and before January 1, 2004.

2. Exclusion of incentive stock options and employee stock purchase plan stock options from wages (sec. 1062 of the bill and secs. 421(b), 423(c), 3121(a), 3231, and 3306(b) of the Code)

PRESENT LAW

Generally, when an employee exercises a compensatory option on employer stock, the difference between the option price and the fair market value of the stock (i.e., the "spread") is includible in income as compensation. In the case of an incentive stock option or an option to purchase stock under an employee stock purchase plan (collectively referred to as "statutory stock options"), the spread is not included in income at the time of exercise.[43]

If the statutory holding period requirements are satisfied with respect to stock acquired through the exercise of a statutory stock option, the spread, and any additional appreciation, will be taxed as capital gain upon disposition of such stock. Compensation income is recognized, however, if there is a disqualifying disposition (i.e., if the statutory holding period is not satisfied) of stock acquired pursuant to the exercise of a statutory stock option.

Federal Insurance Contribution Act ("FICA") and Federal Unemployment Tax Act ("FUTA") taxes (collectively referred to as "employment taxes") are generally imposed in an amount equal to a percentage of wages paid by the employer with respect to employment.[44] The applicable Code provisions[45] do not provide a specific exception from FICA and FUTA taxes for wages paid to an employee arising from the exercise of a statutory stock option, i.e., for

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[43] Sec. 421. For purposes of the individual alternative minimum tax, the transfer of stock pursuant to an incentive stock option is generally treated as the transfer of stock pursuant to a nonstatutory option. Sec. 56(b)(3).

[44] Secs. 3101, 3111 and 3301.

[45] Secs. 3121 and 3306

the excess of the fair market value of the stock at the time of exercise over the amount paid for the stock by the individual.

In January 2001, the Internal Revenue Service issued notice of its intent to clarify, through future guidance, the application of FICA, FUTA, and Federal income tax withholding to statutory stock options.[46] Proposed Treasury regulations issued in November 2001 provided that the payment of FICA and FUTA taxes upon the exercise of statutory stock options would apply to the exercise of statutory stock options on or after January 1, 2003.[47] Federal income tax withholding was not required under the proposed regulations.

On June 25, 2002, the IRS announced that until further guidance is issued, it would not assess FICA or FUTA taxes, or impose Federal income tax withholding obligations, upon either the exercise of a statutory stock option or the disposition of stock acquired pursuant to the exercise of a statutory stock option.[48]

REASONS FOR CHANGE

To provide taxpayers certainty, the Committee believes that it is appropriate to clarify the treatment of statutory stock options for employment tax and income tax withholding purposes. The Committee believes that in the past, the IRS has been inconsistent in its treatment of taxpayers with respect to this issue and did not uniformly challenge taxpayers who did not collect employment taxes and withhold income taxes on statutory stock options.

Until January 2001, the IRS had not published guidance with respect to the imposition of employment taxes and income tax withholding on statutory stock options. Many taxpayers relied on guidance published with respect to qualified stock options (the predecessor to incentive stock options) to take the position that no employment taxes or income tax withholding were required with respect to statutory stock options. It is the Committee's belief that a majority of taxpayers did not withhold employment and income taxes with respect to statutory stock options. Thus, the proposed IRS regulations would have altered the treatment of statutory stock options for most employers.

Because there is a specific income tax exclusion with respect to statutory stock options, the Committee believes it is appropriate to clarify that there is a conforming exclusion for employment taxes and income tax withholding. Statutory stock options are required to meet certain Code requirements that do not apply to nonqualified stock options. The Committee believes that such requirements are intended to make statutory stock options a tool of employee ownership rather than a form of compensation subject to employment taxes. Furthermore, this clarification will ensure that, if further IRS guidance is issued, employees will not be faced with a tax increase that will reduce their net paychecks even though their total compensation has not changed.

The clarification will also eliminate the administrative burden and cost to employers who, in the absence of the Committee bill, could be required to modify their payroll systems to provide for the

[46] Notice 2001–14, 2001–6 I.R.B. 516.
[47] 66 Fed. Reg. 57023 (Nov. 14, 2001).
[48] Notice 2002–47, 2002–28 I.R.B. 97.

withholding of income and employment taxes on statutory stock options that they are not currently required to withhold.

EXPLANATION OF PROVISION

The provision provides specific exclusions from FICA and FUTA wages for remuneration on account of the transfer of stock pursuant to the exercise of an incentive stock option or under an employee stock purchase plan, or any disposition of such stock. Thus, under the provision, FICA and FUTA taxes do not apply upon the exercise of a statutory stock option.[49] The provision also provides that such remuneration is not taken into account for purposes of determining Social Security benefits.

Additionally, the provision provides that Federal income tax withholding is not required on a disqualifying disposition, nor when compensation is recognized in connection with an employee stock purchase plan discount. Present-law reporting requirements continue to apply.

EFFECTIVE DATE

The provision is effective for stock acquired pursuant to options exercised after the date of enactment.

3. Extension of provision permitting qualified transfers of excess pension assets to retiree health accounts (sec. 1063 of the bill and sec. 420 of the Code)

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 of plan assets to the employer 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.[50] 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[51] over the greater of (1) the lesser of (a) the ac-

[49] The provision also provides a similar exclusion under the Railroad Retirement Tax Act.
[50] Sec. 420.
[51] The value of plan assets for this purpose is the lesser of fair market value or acturial value.

crued liability under the plan (including normal cost) or (b) 170 percent of the plan's current liability (for 2003),[52] 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 retiree medical benefits through the separate account. Retiree health benefits of key employees may not be paid out of transferred assets.

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

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

In order 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, employee representatives, and the plan administrator of the transfer, and the plan administrator must notify each plan participant and beneficiary of the transfer.[53]

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

REASONS FOR CHANGE

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

EXPLANATION OF PROVISION

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

EFFECTIVE DATE

The provision is effective on the date of enactment.

[52] These amounts relate to the full funding limit for defined benefit plans. The current liability full funding limit is repealed for years beginning after 2003. Under the general sunset provision of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") the limit is reinstated for years after 2010.

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

G. Treatment of Active Income

1. Treatment of European Union as one country for purposes of the foreign base company sales and services rules (sec. 1071 of the bill and sec. 954 of the Code)

PRESENT LAW

In general, the subpart F rules (secs. 951–964) require U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation to include currently in income for U.S. tax purposes certain passive and other income of the controlled foreign corporation (referred to as "subpart F income"), without regard to whether the income is distributed to the shareholders (sec. 951(a)(1)(A)). In effect, the Code treats the U.S. 10-percent shareholders of a controlled foreign corporation as having received a current distribution of their pro rata shares of the controlled foreign corporation's subpart F income. The amounts included in income by the controlled foreign corporation's U.S. 10-percent shareholders under these rules are subject to U.S. tax currently. The U.S. tax on such amounts may be reduced through foreign tax credits.

Subpart F income encompasses certain categories of non-passive income, including foreign base company sales and services income (sec. 954(a)). Foreign base company sales income generally consists of sales income of a controlled foreign corporation located in a country that is neither the origin nor the destination of the goods with respect to sales of property purchased from or sold to a related person (sec. 954(d)). Foreign base company services income consists of income from services performed outside the controlled foreign corporation's country of incorporation for or on behalf of a related party (sec. 954(e)).

A special branch rule applies only for purposes of determining a controlled foreign corporation's foreign base company sales income. Under this rule, a branch of a controlled foreign corporation is treated as a separate corporation where the activities of the controlled foreign corporation through the branch outside the controlled foreign corporation's country of incorporation have substantially the same effect as if such branch were a subsidiary (sec. 954(d)(2)).

For purposes of the subpart F rules, a related person is defined as any individual, corporation, trust, or estate that controls or is controlled by the controlled foreign corporation, or any individual, corporation, trust, or estate that is controlled by the same person or persons that control the controlled foreign corporation (sec. 954(d)(3)). Control with respect to a corporation means ownership of more than 50 percent of the corporation's stock (by vote or value). Control with respect to a partnership, trust, or estate means ownership of more than 50 percent of the value of the beneficial interests of the partnership, trust, or estate. Indirect and constructive ownership rules apply.

The European Union ("EU") is a union of independent states founded with a goal to enhance political, economic and social co-operation between its members. For example, the EU member states have entered into a series of agreements, including the Parent-Subsidiary Directive, that remove certain intra-EU cross-border tax barriers between EU companies, thereby providing a tax advantage to EU-based companies with EU subsidiaries over U.S.-based companies with EU subsidiaries. The current member states of the EU are Belgium, Denmark, Germany, Greece, Spain, France, Ireland, Italy, Luxembourg, The Netherlands, Austria, Portugal, Sweden, Finland and the United Kingdom. As of January 1, 2004, the European Union will admit Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia. Bulgaria, Romania and Turkey have applied for admittance.

REASONS FOR CHANGE

Because the EU has taken steps to remove barriers to trade between member states and to create a single market in which goods, services and capital can move freely between members, the Committee believes that the foreign base company sales and foreign base company services rules should be revised to allow U.S.-based companies to structure their operations in a way that reflects these developments. The Committee further believes that these changes are necessary to ensure that U.S. companies can compete on a more even basis against their foreign competitors. The Committee believes that this change will increase U.S. company competitiveness in the EU and increase exports from the United States, thus increasing U.S. production and U.S. jobs.

The Committee notes the importance of continuing to examine the operation of these rules, which were enacted over 40 years ago. The Committee believes that it is important for Congress and the Department of the Treasury to look closely at further updating these outdated rules that, for example, include rules that were developed before the dramatic evolution of the service sector in the global economy.

DESCRIPTION OF PROVISION

The proposal treats all of the member states of the EU as one country for purposes of the foreign base company sales and foreign base company services rules.

EFFECTIVE DATE

The provision is effective for taxable years of foreign corporations beginning after December 31, 2008, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

2. Look-through treatment of payments between related controlled foreign corporations under foreign personal holding company income rules (sec. 1072 of the bill and sec. 954 of the Code)

PRESENT LAW

In general, the rules of subpart F (secs. 951–964) require U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation to include certain income of the controlled foreign corporation (referred to as “subpart F income”) on a current basis for U.S. tax purposes, regardless of whether the income is distributed to the shareholders.

Subpart F income includes foreign base company income. One category of foreign base company income is foreign personal holding company income. For subpart F purposes, foreign personal holding company income generally includes dividends, interest, rents and royalties, among other types of income. However, foreign personal holding company income does not include dividends and interest received by a controlled foreign corporation from a related corporation organized and operating in the same foreign country in which the controlled foreign corporation is organized, or rents and royalties received by a controlled foreign corporation from a related corporation for the use of property within the country in which the controlled foreign corporation is organized. Interest, rent, and royalty payments do not qualify for this exclusion to the extent that such payments reduce the subpart F income of the payor.

REASONS FOR CHANGE

Most countries allow their companies to redeploy foreign active earnings with no additional tax burden. In fact, many countries, including several EU countries, do not impose a home country tax on active income earned outside the home country's borders. The Committee believes that this provision will make U.S. companies and U.S. workers more competitive with respect to such countries. By allowing U.S. companies to reinvest their active foreign earnings where they are most needed without incurring the immediate additional tax that companies based in many other countries never incur, the Committee believes that the provision will enable U.S. companies to make more sales overseas, and thus, produce more goods in the United States.

EXPLANATION OF PROVISION

Under the provision, dividends, interest, rents, and royalties received by one controlled foreign corporation from a related controlled foreign corporation are not treated as foreign personal holding company income to the extent attributable to non-subpart-F earnings of the payor. For these purposes, a related controlled foreign corporation is a controlled foreign corporation that controls or is controlled by the other controlled foreign corporation, or a controlled foreign corporation that is controlled by the same person or persons that control the other controlled foreign corporation. Ownership of more than 50 percent of the controlled foreign corporation's stock (by vote or value) constitutes control for these purposes.

EFFECTIVE DATE

The provision is effective for taxable years of foreign corporations beginning after December 31, 2006, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

3. Look-through treatment for sales of partnership interests (sec. 1073 of the bill and sec. 954 of the Code)

PRESENT LAW

In general, the subpart F rules (secs. 951–964) require U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation to include in income currently for U.S. tax purposes certain types of income of the controlled foreign corporation, whether or not such income is actually distributed currently to the shareholders (referred to as "subpart F income"). Subpart F income includes foreign personal holding company income. Foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents, and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and REMICs; (3) net gains from commodities transactions; (4) net gains from foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; and (7) payments in lieu of dividends. Thus, if a controlled foreign corporation sells a partnership interest at a gain, the gain generally constitutes foreign personal holding company income and is included in the income of 10-percent U.S. shareholders of the controlled foreign corporation as subpart F income.

REASONS FOR CHANGE

The Committee believes that the sale of a partnership interest by a controlled foreign corporation that owns a significant interest in the partnership should constitute subpart F income only to the extent that a proportionate sale of the underlying partnership assets attributable to the partnership interest would constitute subpart F income.

EXPLANATION OF PROVISION

The provision treats the sale by a controlled foreign corporation of a partnership interest as a sale of the proportionate share of partnership assets attributable to such interest for purposes of determining subpart F foreign personal holding company income. This rule applies only to partners owning directly or indirectly at least 25 percent of a capital or profits interest in the partnership. Thus, the sale of a partnership interest by a controlled foreign corporation that meets this ownership threshold constitutes subpart F income under the provision only to the extent that a proportionate sale of the underlying partnership assets attributable to the partnership interest would constitute subpart F income.

EFFECTIVE DATE

The provision is effective for taxable years of foreign corporations beginning after December 31, 2006, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

4. Repeal of foreign personal holding company rules and foreign investment company rules (sec. 1074 of the bill and secs. 542, 551–558, 954, 1246, and 1247 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. persons that hold 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 those 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. The foreign tax credit may reduce the U.S. tax imposed on such income.

Several sets of anti-deferral rules impose current U.S. tax on certain income earned by a U.S. person through a foreign corporation. Detailed rules for coordination among the anti-deferral rules are provided to prevent the U.S. person from being subject to U.S. tax on the same item of income under multiple rules.

The Code sets forth the following anti-deferral rules: the controlled foreign corporation rules of subpart F (secs. 951–964); the passive foreign investment company rules (secs. 1291–1298); the foreign personal holding company rules (secs. 551–558); the personal holding company rules (secs. 541–547); the accumulated earnings tax rules (secs. 531–537); and the foreign investment company rules (secs. 1246–1247).

REASONS FOR CHANGE

The Committee believes that the overlap among the various anti-deferral regimes results in significant complexity usually with little or no ultimate tax consequences. These overlaps require the application of specific rules of priority for income inclusions among the regimes, as well as additional coordination provisions pertaining to other operational differences among the various regimes.

EXPLANATION OF PROVISION

The provision: (1) eliminates the rules applicable to foreign personal holding companies and foreign investment companies; (2) excludes foreign corporations from the application of the personal holding company rules; and (3) includes as subpart F foreign personal holding company income personal services contract income that is subject to the present-law foreign personal holding company rules.

EFFECTIVE DATE

The provision is effective for taxable years of foreign corporations beginning after December 31, 2006, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

5. Subpart F treatment of pipeline transportation income (sec. 1075 of the bill and sec. 954 of the Code)

PRESENT LAW

Under the subpart F rules, U.S. 10-percent shareholders of a controlled foreign corporation are subject to U.S. tax currently on their shares of certain income earned by the foreign corporation, whether or not such income is distributed to the shareholders (referred to as “subpart F income”). Subpart F income includes foreign base company income, which in turn includes foreign base company oil related income (sec. 954(a)).

Foreign base company oil related income is income derived outside the United States from the processing of minerals extracted from oil or gas wells into their primary products; the transportation, distribution, or sale of such minerals or primary products; the disposition of assets used by the taxpayer in a trade or business involving the foregoing; or the performance of any related services. However, foreign base company oil related income does not include income derived from a source within a foreign country in connection with: (1) oil or gas which was extracted from a well located in such foreign country or, (2), oil, gas, or a primary product of oil or gas which is sold by the controlled foreign corporation or a related person for use or consumption within such foreign country or is loaded in such country as fuel on a vessel or aircraft. An exclusion also is provided for income of a controlled foreign corporation that is a small producer (i.e., a corporation whose average daily oil and natural gas production, including production by related corporations, is less than 1,000 barrels).

REASONS FOR CHANGE

The subpart F rules were designed to impose immediate U.S. taxation on passive and certain other income earned outside the borders of the United States. The construction of an oil or gas pipeline and the movement of oil or gas through that pipeline are not passive activities, and the Committee believes that the income from these activities is not the kind of income that the subpart F rules were designed to cover.

EXPLANATION OF PROVISION

The provision provides an additional exception to the definition of foreign base company oil related income. Under the provision, foreign base company oil related income does not include income derived from a source within a foreign country in connection with the pipeline transportation of oil or gas within such foreign country. Thus, the exception applies whether or not the controlled foreign corporation that owns the pipeline also owns any interest in the oil or gas transported. In addition, the exception applies to income earned from the transportation of oil or gas by pipeline in a country in which the oil or gas was neither extracted nor consumed within such foreign country.

EFFECTIVE DATE

The provision is effective for taxable years of foreign corporations beginning after December 31, 2004, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

6. Determination of foreign personal holding company income with respect to transactions in commodities (sec. 1076 of the bill and sec. 954 of the Code)

PRESENT LAW

Subpart F foreign personal holding company income

Under the subpart F rules, U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation ("U.S. 10-percent shareholders") are subject to U.S. tax currently on certain income earned by the controlled foreign corporation, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, "foreign personal holding company income."

Foreign personal holding company income generally consists of the following: dividends, interest, royalties, rents and annuities; net gains from sales or exchanges of (1) property that gives rise to the foregoing types of income, (2) property that does not give rise to income, and (3) interests in trusts, partnerships, and real estate mortgage investment conduits ("REMICs"); net gains from commodities transactions; net gains from foreign currency transactions; income that is equivalent to interest; income from notional principal contracts; and payments in lieu of dividends.

With respect to transactions in commodities, foreign personal holding company income does not consist of gains or losses which arise out of bona fide hedging transactions that are reasonably necessary to the conduct of any business by a producer, processor, merchant, or handler of a commodity in the manner in which such business is customarily and usually conducted by others. In addition, foreign personal holding company income does not consist of gains or losses which are comprised of active business gains or losses from the sale of commodities, but only if substantially all of the controlled foreign corporation's business is as an active producer, processor, merchant, or handler of commodities.[54]

Hedging transactions

Under present law, the term "capital asset" does not include any hedging transaction which is clearly identified as such before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe).[55] The term "hedging transaction" means any transaction entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily: (1) to manage risk of price changes or currency fluctuations with respect to ordinary property which is held or to be held by the taxpayer; (2) to manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer; or (3) to manage such other risks as the Secretary may prescribe in regulations.[56]

REASONS FOR CHANGE

The Committee believes that the exceptions from subpart F foreign personal holding company income for commodities hedging transactions and active business sales of commodities should be modified to better reflect current active business practices and, in the case of hedging transactions, to simplify the present-law rules by providing more consistency with the generally applicable definition of a hedging transaction.

[54] Treasury regulations provide that substantially all of a controlled foreign corporation's business is as an active producer, processor, merchant or handler of commodities if the sum of its gross receipts from active sales of commodities in such capacity and commodities hedging transactions that qualify for exclusion from the definition of foreign personal holding company income, equals or exceeds 85 percent of its total receipts for the taxable year (computed as though the controlled foreign corporation was a domestic corporation) (Treas. Reg. sec. 1.954–2(f)(2)(iii)(C)).

[55] Sec. 1221(a)(7).

[56] Sec. 121(b)(2)(A).

EXPLANATION OF PROVISION

The provision modifies the requirements that must be satisfied for gains or losses from a commodities hedging transaction to qualify for exclusion from the definition of subpart F foreign personal holding company income. Under the provision, gains or losses from a transaction with respect to a commodity are not treated as foreign personal holding company income if the transaction satisfies the general definition of a hedging transaction under section 1221(b)(2). For purposes of this provision, the general definition of a hedging transaction under section 1221(b)(2) is modified to include any transaction with respect to a commodity entered into by a controlled foreign corporation in the normal course of the controlled foreign corporation's trade or business primarily: (1) to manage risk of price changes or currency fluctuations with respect to ordinary property or property described in section 1231(b) which is held or to be held by the controlled foreign corporation; or (2) to manage such other risks as the Secretary may prescribe in regulations. Gains or losses from a transaction that satisfies the modified definition of a hedging transaction are excluded from the definition of foreign personal holding company income only if the transaction is clearly identified as a hedging transaction in accordance with the hedge identification requirements that apply generally to hedging transactions under section 1221(b)(2).[57]

The provision also changes the requirements that must be satisfied for active business gains or losses from the sale of commodities to qualify for exclusion from the definition of foreign personal holding company income. Under the provision, such gains or losses are not treated as foreign personal holding company income if substantially all of the controlled foreign corporation's commodities are comprised of: (1) stock in trade of the controlled foreign corporation or other property of a kind which would properly be included in the inventory of the controlled foreign corporation if on hand at the close of the taxable year, or property held by the controlled foreign corporation primarily for sale to customers in the ordinary course of the controlled foreign corporation's trade or business; (2) property that is used in the trade or business of the controlled foreign corporation and is of a character which is subject to the allowance for depreciation under section 167; or (3) supplies of a type regularly used or consumed by the controlled foreign corporation in the ordinary course of a trade or business of the controlled foreign corporation.[58]

EFFECTIVE DATE

The provision is effective with respect to transactions entered into after December 31, 2004.

[57] Sec. 1221(a)(7) and (b)(2)(B).

[58] For purposes of determining whether substantially all of the controlled foreign corporation's commodities are comprised of such property, it is intended that the 85-percent requirement provided in the current Treasury regulations (as modified to reflect the change made by the proposal) continue to apply.

7. Repeal controlled foreign corporation rules for foreign base company shipping income (sec. 1077 of the bill and sec. 954 of the Code)

PRESENT LAW

In general, the subpart F rules (secs. 951–964) require U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation to include currently in income for U.S. tax purposes certain income of the controlled foreign corporation (referred to as "subpart F income"), without regard to whether the income is distributed to the shareholders (sec. 951(a)(1)(A)). In effect, the Code treats the U.S. 10-percent shareholders of a controlled foreign corporation as having received a current distribution of their pro rata shares of the controlled foreign corporation's subpart F income. The amounts included in income by the controlled foreign corporation's U.S. 10-percent shareholders under these rules are subject to U.S. tax currently. The U.S. tax on such amounts may be reduced through foreign tax credits.

Subpart F income includes foreign base company shipping income (sec. 954(f)). Foreign base company shipping income generally includes income derived from the use of an aircraft or vessel in foreign commerce, the performance of services directly related to the use of any such aircraft or vessel, the sale or other disposition of any such aircraft or vessel, and certain space or ocean activities (e.g., leasing of satellites for use in space). Foreign commerce generally involves the transportation of property or passengers between a port (or airport) in the U.S. and a port (or airport) in a foreign country, two ports (or airports) within the same foreign country, or two ports (or airports) in different foreign countries. In addition, foreign base company shipping income includes dividends and interest that a controlled foreign corporation receives from certain foreign corporations and any gains from the disposition of stock in certain foreign corporations, to the extent the dividends, interest, or gains are attributable to foreign base company shipping income. Foreign base company shipping income also includes incidental income derived in the course of active foreign base company shipping operations (e.g., income from temporary investments in or sales of related shipping assets), foreign exchange gain or loss attributable to foreign base company shipping operations, and a controlled foreign corporation's distributive share of gross income of any partnership and gross income received from certain trusts to the extent that the income would have been foreign base company shipping income had it been realized directly by the corporation.

Subpart F income also includes foreign personal holding company income (sec. 954(c)). For subpart F purposes, foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and REMICS; (3) net gains from commodities transactions; (4) net gains from foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; and (7) payments in lieu of dividends.

Subpart F foreign personal holding company income does not include rents and royalties received by the controlled foreign corporation in the active conduct of a trade or business from unrelated persons (sec. 954(c)(2)(A)). Also generally excluded are dividends and interest received by the controlled foreign corporation from a related corporation organized and operating in the same foreign country in which the controlled foreign corporation was organized, and rents and royalties received by the controlled foreign corporation from a related corporation for the use of property within the country in which the controlled foreign corporation was organized (sec. 954(c)(3)). However, interest, rent, and royalty payments do not qualify for this exclusion to the extent that such payments reduce subpart F income of the payor.

REASONS FOR CHANGE

In general, other countries do not tax foreign shipping income, whereas the United States imposes immediate U.S. tax on such income. The noncompetitive U.S. taxation of shipping income has directly caused a steady and substantial decline of the U.S. shipping industry. The Committee believes that this provision will provide U.S. shippers the opportunity to be competitive with their tax-advantaged foreign competitors.

EXPLANATION OF PROVISION

The provision repeals the subpart F rules relating to foreign base company shipping income (sec. 954(f)). The bill also amends the exception from foreign personal holding company income applicable to rents or royalties derived from unrelated persons in an active trade or business (sec. 954(c)(2)(A)), by providing a safe harbor for rents derived from leasing an aircraft or vessel in foreign commerce. Such rents are excluded from foreign personal holding company income if the active leasing expenses comprise at least 10-percent of the profit on the lease. This provision is to be applied in accordance with existing regulations under sec. 954(c)(2)(A) by comparing the lessor's "active leasing expenses" for its pool of leased assets to its "adjusted leasing profit."

The safe harbor will not prevent a lessor from otherwise showing that it actively carries on a trade or business. In this regard, the requirements of section 954(c)(2)(A) will be met if a lessor regularly and directly performs active and substantial marketing, remarketing, management and operational functions with respect to the leasing of an aircraft or vessel (or component engines). This will be the case regardless of whether the lessor engages in marketing of the lease as a form of financing (versus marketing the property as such) or whether the lease is classified as a finance lease or operating lease for financial accounting purposes. If a lessor acquires, from an unrelated or related party, a ship or aircraft subject to an existing FSC or ETI lease, the requirements of section 954(c)(2)(A) will be satisfied if, following the acquisition, the lessor performs active and substantial management, operational, and remarketing functions with respect to the leased property. If such a lease is transferred to a CFC lessor, it will no longer be eligible for FSC or ETI benefits.

An aircraft or vessel will be considered to be leased in foreign commerce if it is used for the transportation of property or passengers between a port (or airport) in the United States and one in a foreign country or between foreign ports (or airports), provided the aircraft or vessel is used predominantly outside the United States. An aircraft or vessel will be considered used predominantly outside the United States if more than 50 percent of the miles during the taxable year are traversed outside the United States or the aircraft or vessel is located outside the United States more than 50 percent of the time during such taxable year.

The Committee expects the Secretary of the Treasury to issue timely guidance to make conforming changes to existing regulations, including guidance that aircraft or vessel leasing activity that satisfies the requirements of section 954(c)(2)(A) shall also satisfy the requirements for avoiding income inclusion under section 956 and section 367(a).

EFFECTIVE DATE

The provision is effective for taxable years of foreign corporations beginning after December 31, 2004, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

8. Modification of subpart F exemption for active financing (sec. 1078 of the bill and sec. 954 of the Code)

PRESENT LAW

Under the subpart F rules, U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation ("CFC") are subject to U.S. tax currently on certain income earned by the CFC, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, foreign personal holding company income and insurance income. In addition, 10-percent U.S. shareholders of a CFC are subject to current inclusion with respect to their shares of the CFC's foreign base company services income (i.e., income derived from services performed for a related person outside the country in which the CFC is organized).

Foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents, and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and REMICs; (3) net gains from commodities transactions; (4) net gains from foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; and (7) payments in lieu of dividends.

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization. Subpart F insurance income also includes income attributable to an insurance contract in connection with risks located within the CFC's country of organization, as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other country risks. Investment income of a CFC that is allocable to any insurance or annuity contract related to risks located outside the CFC's country of organization is taxable as subpart F insurance income (Treas. Reg. sec. 1.953–1(a)).

Temporary exceptions from foreign personal holding company income, foreign base company services income, and insurance income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business (so-called "active financing income").[59]

With respect to income derived in the active conduct of a banking, financing, or similar business, a CFC is required to be predominantly engaged in such business and to conduct substantial activity with respect to such business in order to qualify for the exceptions. In addition, certain nexus requirements apply, which provide that income derived by a CFC or a qualified business unit ("QBU") of a CFC from transactions with customers is eligible for the exceptions if, among other things, substantially all of the activities in connection with such transactions are conducted directly by the CFC or QBU in its home country, and such income is treated as earned by the CFC or QBU in its home country for purposes of such country's tax laws. Moreover, the exceptions apply to income derived from certain cross border transactions, provided that certain requirements are met. Additional exceptions from foreign personal holding company income apply for certain income derived by a securities dealer within the meaning of section 475 and for gain from the sale of active financing assets.

In the case of insurance, in addition to temporary exceptions from insurance income and from foreign personal holding company income for certain income of a qualifying insurance company with respect to risks located within the CFC's country of creation or organization, temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of a qualifying branch of a qualifying insurance company with respect to risks located within the home country of the branch, provided certain requirements are met under each of the exceptions. Further, additional temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of certain CFCs or branches with respect to risks located in a country other than the United States, provided that the requirements for these exceptions are met.

REASONS FOR CHANGE

The Committee believes that the rules for determining whether income earned by an eligible CFC or QBU is active financing income should be more consistent with the rules for determining whether a CFC or QBU is eligible to earn active financing income.

[59] Temporary exceptions from the subpart F provisions for certain active financing income applied only for taxable years beginning in 1998. Those exceptions were modified and extended for one year, applicable only for taxable years beginning in 1999. The Tax Relief Extension Act of 1999 (P.L. No. 106–170) clarified and extended the temporary exceptions for two years, applicable only for taxable years beginning after 1999 and before 2002. The Job Creation and Worker Assistance Act of 2002 (P.L. No. 107–147) extended the temporary exceptions for five years, applicable only for taxable years beginning after 2001 and before 2007, with a modification relating to insurance reserves.

EXPLANATION OF PROVISION

The provision modifies the present-law temporary exceptions from subpart F foreign personal holding company income and foreign base company services income for income derived in the active conduct of a banking, financing, or similar business. For purposes of determining whether a CFC or QBU has conducted directly in its home country substantially all of the activities in connection with transactions with customers, the provision provides that an activity is treated as conducted directly by the CFC or QBU in its home country if the activity is performed by employees of a related person and: (1) the related person is itself an eligible CFC the home country of which is the same as that of the CFC or QBU; (2) the activity is performed in the home country of the related person; and (3) the related person is compensated on an arm's length basis for the performance of the activity by its employees and such compensation is treated as earned by such person in its home country for purposes of the tax laws of such country. For purposes of determining whether a CFC or QBU is eligible to earn active financing income, such activity may not be taken into account by any CFC or QBU (including the employer of the employees performing the activity) other than the CFC or QBU for which the activities are performed.

EFFECTIVE DATE

The provision is effective for taxable years of foreign corporations beginning after December 31, 2004, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

9. Partial exclusion for qualified film income (sec. 1079 of the bill and new sec. 139A of the Code)

PRESENT LAW

In general

Present law provides that gross income for U.S. tax purposes does not include extraterritorial income. Because the exclusion of such extraterritorial income is a means of avoiding double taxation, no foreign tax credit is allowed for income taxes paid with respect to such excluded income. Extraterritorial income is eligible for the exclusion to the extent that it is "qualifying foreign trade income."

Qualifying foreign trade income

"Qualifying foreign trade income" is the amount of gross income that, if excluded, would result in a reduction of taxable income by the greatest of (1) 1.2 percent of the "foreign trading gross receipts" derived by the taxpayer from the transaction, (2) 15 percent of the "foreign trade income" derived by the taxpayer from the transaction, or (3) 30 percent of the "foreign sale and leasing income" derived by the taxpayer from the transaction. The amount of qualifying foreign trade income determined using 1.2 percent of the foreign trading gross receipts is limited to 200 percent of the qualifying foreign trade income that would result using 15 percent of the foreign trade income. Although these calculations are determined by reference to a reduction of taxable income (a net income concept), qualifying foreign trade income is an exclusion from gross income.

Foreign trading gross receipts

"Foreign trading gross receipts" are gross receipts derived from certain activities in connection with "qualifying foreign trade property" with respect to which certain "economic processes" take place outside of the United States. The threshold for determining if gross receipts will be treated as foreign trading gross receipts is whether the gross receipts are derived from a transaction involving "qualifying foreign trade property."

Qualifying foreign trade property is property manufactured, produced, grown, or extracted within or outside of the United States that is held primarily for sale, lease, or rental, in the ordinary course of a trade or business, for direct use, consumption, or disposition outside of the United States. In addition, not more than 50 percent of the fair market value of such property can be attributable to the sum of (1) the fair market value of articles manufactured outside of the United States, plus (2) the direct costs of labor performed outside of the United States. Certain property is excluded from the definition of qualifying foreign trade property, including patents, inventions, models, designs, formulas, or processes whether or not patented, copyrights (other than films, tapes, records, or similar reproductions, and other than computer software (whether or not patented), for commercial or home use), goodwill, trademarks, trade brands, franchises, or other like property. Consequently, gross receipts from the license of films for reproduction abroad generally constitutes foreign trading gross receipts.

Foreign trade income

"Foreign trade income" is the taxable income of the taxpayer (determined without regard to the exclusion of qualifying foreign trade income) attributable to foreign trading gross receipts. Certain dividends-paid deductions of cooperatives are disregarded in determining foreign trade income for this purpose.

Foreign sale and leasing income

"Foreign sale and leasing income" is the amount of the taxpayer's foreign trade income (with respect to a transaction) that is properly allocable to activities that constitute foreign economic processes.

REASONS FOR CHANGE

The Committee recognizes that the extraterritorial income ("ETI") regime must be repealed and that its repeal constitutes a significant tax increase on the United States motion picture and film industry. In addition, the Committee understands that over the past decade, production of some American film projects has moved to foreign locations, as a number of foreign governments have offered tax and other incentives designed to entice production of motion pictures and television programs to their countries. Consequently, the Committee believes that it is appropriate to provide tax relief for motion pictures and films made in the United States.

EXPLANATION OF PROVISION

The provision provides an exclusion from gross income for an amount equal to the applicable percentage of qualified film income. "Qualified film income" is defined as a taxpayer's gross income from the license of a qualified film for the exploitation or direct use outside the United States less all associated film costs.[60] Qualified film income does not include any gross income from the exploitation of characters, soundtracks, designs, scripts, scores, or other ancillary intangibles. For example, gross income from the foreign theatrical, home video, digital video disc, and television markets would be eligible for the provision, whereas gross income from the foreign license of characters, scripts, video and board games, and other ancillary intangibles of such film would not be eligible for the provision. In addition, qualified film income does not include any amount from the license of a qualified film to a related person[61] unless such film is held for license by such related person to an unrelated person for the exploitation or direct use by such unrelated person outside the United States.

For purposes of the provision, the applicable percentage for taxable years ending in 2007 is one percent, in 2008 is two percent, in 2009 is three percent, in 2010 is five percent, in 2011 is eight percent, in 2012 is nine percent, and after 2012 is ten percent.

A "qualified film" is defined as property described in section 168(f)(3) the original use of which commences after December 31, 2006 if (excluding compensation in the form of residuals and participations) 50 percent or more of the total compensation relating to the production of such film constitutes compensation for services performed in the United States by actors, production personnel, directors, and producers. However, a qualified film does not include sexually explicit productions as defined by section 2257 of title 18 of the U.S. Code.

The provision provides that no foreign tax credit or deduction is allowed for foreign taxes paid or accrued with respect to the excludible portion of any qualified film income. In addition, the provision provides that a taxpayer may elect not to apply the provision to a qualified film. Such election shall be made by the due date (including extensions of time) for filing the taxpayer's return for the taxable year in which the qualified film is placed in service.

EFFECTIVE DATE

The provision is effective for taxable years ending after December 31, 2006.

[60] Associated film costs is defined as any expense properly apportioned and allocated to qualified film income, determined as provided under regulations prescribed by the Secretary.

[61] A person is related to another person if such persons are treated as a single employer under subsection (a) or (b) of section 52 or subsection (m) or (o) of section 414, except that determinations under subsections (a) and (b) of section 52 are made without regard to section 1563(b).

H. Reduction of Double Taxation of Earnings

1. Interest expense allocation rules (sec. 1081 of the bill and sec. 864 of the Code)

PRESENT LAW

In general

In order to compute the foreign tax credit limitation, a taxpayer must determine the amount of its taxable income from foreign sources. Thus, the taxpayer must allocate and apportion deductions between items of U.S.-source gross income, on the one hand, and items of foreign-source gross income, on the other.

In the case of interest expense, the rules generally are based on the approach that money is fungible and that interest expense is properly attributable to all business activities and property of a taxpayer, regardless of any specific purpose for incurring an obligation on which interest is paid. (Exceptions to the fungibility concept are recognized or required, however, in particular cases, some of which are described below). The Code provides that for interest allocation purposes all members of an affiliated group of corporations generally are to be treated as a single corporation (the so-called "one-taxpayer rule"), and that allocation must be made on the basis of assets rather than gross income.

Affiliated group

In general

The term "affiliated group" in this context generally is defined by reference to the rules for determining whether corporations are eligible to file consolidated returns. However, some groups of corporations are eligible to file consolidated returns yet are not treated as affiliated for interest allocation purposes, and other groups of corporations are treated as affiliated for interest allocation purposes even though they are not eligible to file consolidated returns. Thus, under the one-taxpayer rule, the factors affecting the allocation of interest expense of one corporation may affect the sourcing of taxable income of another, related corporation even if the two corporations do not elect to file, or are ineligible to file, consolidated returns.

Definition of affiliated group—consolidated return rules

For consolidation purposes, the term "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation, but only if: (1) the common parent owns directly stock possessing at least 80 percent of the total voting power and at least 80 percent of the total value of at least one other includible corporation; and (2) stock meeting the same voting power and value standards with respect to each includible corporation (excluding the common parent) is directly owned by one or more other includible corporations.

Generally, the term "includible corporation" means any domestic corporation except certain corporations exempt from tax under section 501 (for example, corporations organized and operated exclusively for charitable or educational purposes), certain life insurance companies, corporations electing application of the possession tax credit, regulated investment companies, real estate investment trusts, and domestic international sales corporations. A foreign corporation generally is not an includible corporation.

Definition of affiliated group—special interest allocation rules

Subject to exceptions, the consolidated return and interest allocation definitions of affiliation generally are consistent with each other.[62] For example, both definitions generally exclude all foreign corporations from the affiliated group. Thus, while debt generally is considered fungible among the assets of a group of domestic affiliated corporations, the same rules do not apply as between the domestic and foreign members of a group with the same degree of common control as the domestic affiliated group.

Banks, savings institutions, and other financial affiliates

The affiliated group for interest allocation purposes generally excludes what are referred to in the Treasury regulations as "financial corporations" (Treas. Reg. sec. 1.861–11T(d)(4)). These include any corporation, otherwise a member of the affiliated group for consolidation purposes, that is a financial institution (described in section 581 or section 591), the business of which is predominantly with persons other than related persons or their customers, and which is required by State or Federal law to be operated separately from any other entity which is not a financial institution (sec. 864(e)(5)(C)). The category of financial corporations also includes, to the extent provided in regulations, bank holding companies, subsidiaries of banks and bank holding companies, and savings institutions predominantly engaged in the active conduct of a banking, financing, or similar business (sec. 864(e)(5)(D)).

A financial corporation is not treated as a member of the regular affiliated group for purposes of applying the one-taxpayer rule to other non-financial members of that group. Instead, all such financial corporations that would be so affiliated are treated as a separate single corporation for interest allocation purposes.

REASONS FOR CHANGE

The Committee observes that the United States is the only country that currently imposes harsh and anti-competitive interest expense allocation rules on its businesses and workers. The present-law interest expense allocation rules result in U.S. companies allocating a portion of their U.S. interest expense against foreign-source income, even when the foreign operation has its own debt. The tax effect of this rule is that U.S. companies end up paying double tax. The practical effect is that the cost for U.S. companies to borrow in the United States is increased and it becomes more expensive to invest in the United States. The Committee believes that these rules should be modified so that U.S. companies are not discouraged from investing in the United States. To this end, U.S. companies should not be required to allocate U.S. interest expense against foreign-source income (and thereby incur double taxation)

[62] One such exception is that the affiliated group for interest allocation purposes includes section 936 corporations that are excluded from the consolidated group.

unless their debt-to-asset ratio is higher in the United States than in foreign countries.

EXPLANATION OF PROVISION

In general

The provision modifies the present-law interest expense allocation rules (which generally apply for purposes of computing the foreign tax credit limitation) by providing a one-time election under which the taxable income of the domestic members of an affiliated group from sources outside the United States generally is determined by allocating and apportioning interest expense of the domestic members of a worldwide affiliated group on a worldwide-group basis (i.e., as if all members of the worldwide group were a single corporation). If a group makes this election, the taxable income of the domestic members of a worldwide affiliated group from sources outside the United States is determined by allocating and apportioning the interest expense of those domestic members to foreign-source income in an amount equal to the excess (if any) of (1) the worldwide affiliated group's worldwide interest expense multiplied by the ratio which the foreign assets of the worldwide affiliated group bears to the total assets of the worldwide affiliated group, over (2) the interest expense incurred by a foreign member of the group to the extent such interest would be allocated to foreign sources if the provision's principles were applied separately to the foreign members of the group.[63]

For purposes of the new elective rules based on worldwide fungibility, the worldwide affiliated group means all corporations in an affiliated group (as that term is defined under present law for interest allocation purposes)[64] as well as all controlled foreign corporations that in the aggregate either directly or indirectly[65] would be members of such an affiliated group if section 1504(b)(3) did not apply (i.e., in which at least 80 percent of the vote and value of the stock of such corporations is owned by one or more other corporations included in the affiliated group). Thus, if an affiliated group makes this election, the taxable income from sources outside the United States of domestic group members generally is determined by allocating and apportioning interest expense of the domestic members of the worldwide affiliated group as if all of the interest expense and assets of 80-percent or greater owned domestic corporations (i.e., corporations that are part of the affiliated group under present-law section 864(e)(5)(A) as modified to include insurance companies) and certain controlled foreign corporations were attributable to a single corporation.

In addition, if an affiliated group elects to apply the new elective rules based on worldwide fungibility, the present-law rules regarding the treatment of tax-exempt assets and the basis of stock in

[63] Although the interest expense of a foreign subsidiary is taken into account for purposes of allocating the interest of the domestic members of the electing worldwide affiliated group for foreign tax credit limitation purposes, the interest expense incurred by a foreign subsidiary is not deductible on a U.S. return.

[64] The provision expands the definition of an affiliated group for interest expense allocation purposes to include certain insurance companies that are generally excluded from an affiliated group under section 1504(b)(2) (without regard to whether such companies are covered by an election under section 1504(c)(2)).

[65] Indirect ownership is determined under the rules of section 958(a)(2) or through applying rules similar to those of section 958(a)(2) to stock owned directly or indirectly by domestic partnerships, trusts, or estates.

nonaffiliated ten-percent owned corporations apply on a worldwide affiliated group basis.

The worldwide affiliated group election is to be made by the common parent of the domestic affiliated group. The election is to be made for the first taxable year, beginning after December 31, 2008, in which a worldwide affiliated group exists that includes at least one foreign corporation that meets the requirements for inclusion in a worldwide affiliated group. Once made, the election applies to the common parent and all other members of the worldwide affiliated group for the taxable year for which the election was made and all subsequent taxable years, unless revoked with the consent of the Secretary.

Financial institution group election

The provision allows taxpayers to apply the present-law bank group rules to exclude certain financial institutions from the affiliated group for interest allocation purposes under the worldwide fungibility approach. The provision also provides a one-time "financial institution group" election that expands the present-law bank group. Under the provision, at the election of the common parent of the pre-election worldwide affiliated group, the interest expense allocation rules are applied separately to a subgroup of the worldwide affiliated group that consists of (1) all corporations that are part of the present-law bank group,[66] and (2) all "financial corporations." For this purpose, a corporation is a financial corporation if at least 80 percent of its gross income is financial services income (as described in section 904(d)(2)(C)(i) and the regulations thereunder) that is derived from transactions with unrelated persons.[67] For these purposes, items of income or gain from a transaction or series of transactions are disregarded if a principal purpose for the transaction or transactions is to qualify any corporation as a financial corporation.

The common parent of the pre-election worldwide affiliated group is to make the election for the first taxable year, beginning after December 31, 2008, in which a worldwide affiliated group includes a financial corporation. Once made, the election applies to the financial institution group for the taxable year and all subsequent taxable years unless revoked with the consent of the Treasury Secretary. In addition, the provision provides anti-abuse rules under which certain transfers from a member of a financial institution group to a member of the worldwide affiliated group outside of the financial institution group are treated as reducing the amount of indebtedness of the separate financial institution group (and increasing the indebtedness of the worldwide affiliated group outside the financial institution group). The provision provides regulatory authority with respect to the election to provide for the direct allocation of interest expense in circumstances in which such allocation is appropriate to carry out the purposes of the provision, prevent

[66] No inference is intended as to the treatment under present law with respect to financial holding companies (within the meaning of section 2(p) of the Bank Holding Company Act of 1956), as well as subsidiaries of financial holding companies that are predominantly engaged (directly or indirectly) in the active conduct of a banking, financing, or similar business. With respect to financial holding companies that make a financial institution group election under the bill, no inference is intended as to the application of present law to such taxpayers for taxable years prior to the taxable year for which such an election is made.

[67] See Treas. Reg. sec. 1.904–4(e)(2).

assets or interest expense from being taken into account more than once, and addressing changes in members of any group (through acquisitions or otherwise) treated as affiliated under this provision.

EFFECTIVE DATE

The provision is effective for taxable years beginning after December 31, 2008.

2. Recharacterization of overall domestic loss (sec. 1082 of the bill and sec. 904 of the Code)

PRESENT LAW

The United States provides a credit for foreign income taxes paid or accrued. The foreign tax credit generally is limited to the U.S. tax liability on a taxpayer's foreign-source income, in order to ensure that the credit serves the purpose of mitigating double taxation of foreign-source income without offsetting the U.S. tax on U.S.-source income. This overall limitation is calculated by prorating a taxpayer's pre-credit U.S. tax on its worldwide income between its U.S.-source and foreign-source taxable income. The ratio (not exceeding 100 percent) of the taxpayer's foreign-source taxable income to worldwide taxable income is multiplied by its pre-credit U.S. tax to establish the amount of U.S. tax allocable to the taxpayer's foreign-source income and, thus, the upper limit on the foreign tax credit for the year.

If a taxpayer's losses from foreign sources exceed its foreign-source income, the excess ("overall foreign loss," or "OFL") may offset U.S.-source income. Such an offset reduces the effective rate of U.S. tax on U.S.-source income.

In order to eliminate a double benefit (that is, the reduction of U.S. tax previously noted and, later, full allowance of a foreign tax credit with respect to foreign-source income), present law includes an OFL recapture rule. Under this rule, a portion of foreign-source taxable income earned after an OFL year is recharacterized as U.S.-source taxable income for foreign tax credit purposes (and for purposes of the possessions tax credit). Unless a taxpayer elects a higher percentage, however, generally no more than 50 percent of the foreign-source taxable income earned in any particular taxable year is recharacterized as U.S.-source taxable income. The effect of the recapture is to reduce the foreign tax credit limitation in one or more years following an OFL year and, therefore, the amount of U.S. tax that can be offset by foreign tax credits in the later year or years.

A U.S.-source loss reduces pre-credit U.S. tax on worldwide income to an amount less than the hypothetical tax that would apply to the taxpayer's foreign-source income if viewed in isolation. The existence of foreign-source taxable income in the year of the U.S.-source loss reduces or eliminates any net operating loss carryover that the U.S.-source loss would otherwise have generated absent the foreign income. In addition, as the pre-credit U.S. tax on worldwide income is reduced, so is the foreign tax credit limitation. As a result, some foreign tax credits in the year of the U.S.-source loss must be credited, if at all, in a carryover year. Tax on U.S.-source taxable income in a subsequent year may be offset by a net operating loss carryforward, but not by a foreign tax credit carryforward. There is currently no mechanism for recharacterizing such subsequent U.S.-source income as foreign-source income.

For example, suppose a taxpayer generates a $100 U.S.-source loss and earns $100 of foreign-source income in Year 1, and pays $30 of foreign tax on the $100 of foreign-source income. Because the taxpayer has no net taxable income in Year 1, no foreign tax credit can be claimed in Year 1 with respect to the $30 of foreign taxes. If the taxpayer then earns $100 of U.S.-source income and $100 of foreign-source income in Year 2, present law does not recharacterize any portion of the $100 of U.S.-source income as foreign-source income to reflect the fact that the previous year's $100 U.S.-source loss reduced the taxpayer's ability to claim foreign tax credits.

REASONS FOR CHANGE

The Committee believes that it is important to create parity in the treatment of overall foreign losses and overall domestic losses in order to prevent the double taxation of income. The Committee believes that preventing double taxation will make U.S. businesses more competitive and will lead to increased export sales. The Committee believes that this increase in export sales will increase production in the United States and increase jobs in the United States to support the increased exports.

EXPLANATION OF PROVISION

The provision applies a re-sourcing rule to U.S.-source income in cases in which a taxpayer's foreign tax credit limitation has been reduced as a result of a prior overall domestic loss. Under the provision, a portion of the taxpayer's U.S.-source income for each succeeding taxable year is recharacterized as foreign-source income in an amount equal to the lesser of: (1) the amount of the unrecharacterized overall domestic loss, and (2) 50 percent of the taxpayer's U.S.-source income for such succeeding taxable year.

The provision defines an overall domestic loss for this purpose as any domestic loss to the extent it offsets foreign-source taxable income for the current taxable year or for any preceding taxable year by reason of a loss carryback. For this purpose, a domestic loss means the amount by which the U.S.-source gross income for the taxable year is exceeded by the sum of the deductions properly apportioned or allocated thereto, determined without regard to any loss carried back from a subsequent taxable year. Under the provision, an overall domestic loss does not include any loss for any taxable year unless the taxpayer elected the use of the foreign tax credit for such taxable year.

Any U.S.-source income recharacterized under the provision is allocated among and increases the various foreign tax credit separate limitation categories in the same proportion that those categories were reduced by the prior overall domestic loss.

It is anticipated that situations may arise in which a taxpayer generates an overall domestic loss in a year following a year in which it had an overall foreign loss, or vice versa. In such a case, it would be necessary for ordering and other coordination rules to be developed for purposes of computing the foreign tax credit limitation in subsequent taxable years. The provision grants the Secretary authority to prescribe such regulations as may be necessary to coordinate the operation of the OFL recapture rules with the operation of the overall domestic loss recapture rules added by the provision.

EFFECTIVE DATE

The provision applies to losses incurred in taxable years beginning after December 31, 2005.

3. Reduction to two foreign tax credit baskets (sec. 1083 of the bill and sec. 904 of the Code)

PRESENT LAW

The United States taxes its citizens and residents on their worldwide income. Because the countries in which income is earned also may assert their jurisdiction to tax the same income on the basis of source, foreign-source income earned by U.S. persons may be subject to double taxation. In order to mitigate this possibility, the United States provides a credit against U.S. tax liability for foreign income taxes paid, subject to a number of limitations. The foreign tax credit generally is limited to the U.S. tax liability on a taxpayer's foreign-source income, in order to ensure that the credit serves its purpose of mitigating double taxation of cross-border income without offsetting the U.S. tax on U.S.-source income.

The foreign tax credit limitation is applied separately to the following categories of income: (1) passive income, (2) high withholding tax interest, (3) financial services income, (4) shipping income, (5) certain dividends received from noncontrolled section 902 foreign corporations ("10/50 companies"),[68] (6) certain dividends from a domestic international sales corporation or former domestic international sales corporation, (7) taxable income attributable to certain foreign trade income, (8) certain distributions from a foreign sales corporation or former foreign sales corporation, and (9) any other income not described in items (1) through (8) (so-called "general basket" income).

REASONS FOR CHANGE

Requiring taxpayers to separate income and tax credits into nine separate tax baskets creates some of the most complex tax reporting and compliance issues in the Code. The Committee believes that reducing the number of foreign tax credit baskets to two greatly simplifies the Code and undoes much of the complexity created by the Tax Reform Act of 1986. The Committee believes that simplifying these rules will reduce double taxation, make U.S. businesses more competitive, and create jobs in the United States.

EXPLANATION OF PROVISION

The provision provides for two foreign tax credit limitation categories: passive category income and general category income. Financial services income is treated as general category income in

[68] Subject to certain exceptions, dividends paid by a 10/50 company in taxable years beginning after December 31, 2002 are subject to either a look-through approach in which the dividend is attributed to a particular limitation category based on the underlying earnings which gave rise to the dividend (for post-2002 earnings and profits), or a single-basket limitation approach for dividends from all 10/50 companies (for pre-2003 earnings and profits). Under section 1115 of the bill, these dividends are subject to a look-through approach, irrespective of when the underlying earnings and profits arose.

the case of (1) a member of a financial services group (i.e., any affiliated group[69] that is predominately engaged in the active conduct of a banking, insurance, financing, or similar business) or (2) any other person predominantly engaged in the active conduct of a banking, insurance, financing, or similar business.[70] Other income is included in one of the two categories, as appropriate. For example, shipping income generally falls into the general limitation category, whereas high withholding tax interest generally could fall into the passive income or the general limitation category, depending on the circumstances. Dividends from a domestic international sales corporation or former domestic international sales corporation, income attributable to certain foreign trade income, and certain distributions from a foreign sales corporation or former foreign sales corporation all are assigned to the passive income limitation category. Creditable foreign taxes that are imposed on amounts that do not constitute income under U.S. tax principles are treated as imposed on general limitation income.

Taxes paid or accrued in a taxable year beginning before January 1, 2005, and carried to any subsequent taxable year are treated as if this provision were in effect on the date such taxes were paid or accrued. Thus, such taxes are assigned to one of the two foreign tax credit limitation categories, as appropriate. The Secretary has the authority to provide regulations relating to the allocation of income with respect to taxes carried back to years in which more than two foreign tax credit limitation categories were in existence.

EFFECTIVE DATE

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

4. Look-through rules to apply to dividends from noncontrolled section 902 corporations (sec. 1084 of the bill 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. Separate limitations are applied to specific categories of income.

Special foreign tax credit limitations apply in the case of dividends received from a foreign corporation in which the taxpayer owns at least 10 percent of the stock by vote and which is not a controlled foreign corporation (a so-called "10/50 company"). Dividends paid by a 10/50 company that is not a passive foreign invest-

[69] The provision expands the definition of an affiliated group as defined under section 1504(a) for these purposes to include certain insurance companies (without regard to whether such companies are covered by an election under 1504(c)(2)) and foreign corporations that are generally excluded from an affiliated group under section 1504(b)(2) and section 1504(b)(3) respectively. In determining whether an affiliated group is predominately engaged in the active conduct of a banking, insurance, financing, or similar business, only the income of members of the group that are U.S. corporations or controlled foreign corporations in which such U.S. corporations own (directly or indirectly) at least 80 percent of total voting power and value of the stock is taken into account.

[70] The provision requires the Secretary to specify the treatment of financial services income received or accrued by pass-through entities that are not members of a financial services group.

ment company out of earnings and profits accumulated in taxable years beginning before January 1, 2003 are subject to a single foreign tax credit limitation for all 10/50 companies (other than passive foreign investment companies).[71] Dividends paid by a 10/50 company that is a passive foreign investment company out of earnings and profits accumulated in taxable years beginning before January 1, 2003, continue to be subject to a separate foreign tax credit limitation for each such 10/50 company. Dividends paid by a 10/50 company out of earnings and profits accumulated in taxable years after December 31, 2002 are treated as income in a foreign tax credit limitation category in proportion to the ratio of the earnings and profits attributable to income in such foreign tax credit limitation category to the total earnings and profits (a "look-through" approach).

For these purposes, distributions are treated as made from the most recently accumulated earnings and profits. Regulatory authority is granted to provide rules regarding the treatment of distributions out of earnings and profits for periods prior to the taxpayer's acquisition of such stock.

REASONS FOR CHANGE

The Committee believes that significant simplification can be achieved by eliminating the requirement that taxpayers segregate the earnings and profits of 10/50 companies on the basis of when such earnings and profits arose.

EXPLANATION OF PROVISION

The provision applies the look-through approach to all dividends paid by a 10/50 company, regardless of the year in which the earnings and profits out of which the dividend is paid were accumulated.[72] If the Secretary determines that the taxpayer has not substantiated which limitation category applies under the look-through approach with respect to all or a portion of the dividend, such portion is treated as passive category income for foreign tax credit purposes.

The provision also provides transition rules regarding the use of pre-effective date foreign tax credits associated with a 10/50 company separate limitation category in post-effective date years. Look-through principles similar to those applicable to post-effective date dividends from a 10/50 company apply to determine the appropriate foreign tax credit limitation category or categories with respect to carrying forward foreign tax credits into future years. The provision provides regulatory authority for the Secretary to address the carryback of foreign tax credits associated with a dividend from a 10/50 company to pre-effective date years.

EFFECTIVE DATE

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

[71] Dividends paid by a 10/50 company in taxable years beginning before January 1, 2003 are subject to a separate foreign tax credit limitation for each 10/50 company.

[72] Section 1113 of the bill eliminates the separate basket for dividends from 10/50 companies.

5. Attribution of stock ownership through partnerships to apply in determining section 902 and 960 credits (sec. 1085 of the bill and secs. 901, 902, and 960 of the Code)

PRESENT LAW

Under section 902, a domestic corporation that receives a dividend from a foreign corporation in which it owns ten percent or more of the voting stock is deemed to have paid a portion of the foreign taxes paid by such foreign corporation. Thus, such a domestic corporation is eligible to claim a foreign tax credit with respect to such deemed-paid taxes. The domestic corporation that receives a dividend is deemed to have paid a portion of the foreign corporation's post-1986 foreign income taxes based on the ratio of the amount of the dividend to the foreign corporation's post-1986 undistributed earnings and profits.

Foreign income taxes paid or accrued by lower-tier foreign corporations also are eligible for the deemed-paid credit if the foreign corporation falls within a qualified group (sec. 902(b)). A "qualified group" includes certain foreign corporations within the first six tiers of a chain of foreign corporations if, among other things, the product of the percentage ownership of voting stock at each level of the chain (beginning from the domestic corporation) equals at least five percent. In addition, in order to claim indirect credits for foreign taxes paid by certain fourth-, fifth-, and sixth-tier corporations, such corporations must be controlled foreign corporations (within the meaning of sec. 957) and the shareholder claiming the indirect credit must be a U.S. shareholder (as defined in sec. 951(b)) with respect to the controlled foreign corporations. The application of the indirect foreign tax credit below the third tier is limited to taxes paid in taxable years during which the payor is a controlled foreign corporation. Foreign taxes paid below the sixth tier of foreign corporations are ineligible for the indirect foreign tax credit.

Section 960 similarly permits a domestic corporation with subpart F inclusions from a controlled foreign corporation to claim deemed-paid foreign tax credits with respect to foreign taxes paid or accrued by the controlled foreign corporation on its subpart F income.

The foreign tax credit provisions in the Code do not specifically address whether a domestic corporation owning ten percent or more of the voting stock of a foreign corporation through a partnership is entitled to a deemed-paid foreign tax credit.[73] In Rev. Rul. 71–141,[74] the IRS held that a foreign corporation's stock held indirectly by two domestic corporations through their interests in a domestic general partnership is attributed to such domestic corporations for purposes of determining the domestic corporations' eligibility to claim a deemed-paid foreign tax credit with respect to the

[73] Under section 901(b)(5), an individual member of a partnership or a beneficiary of an estate or trust generally may claim a direct foreign tax credit with respect to the amount of his or her proportionate share of the foreign taxes paid or accrued by the partnership, estate, or trust. This rule does not specifically apply to corporations that are either members of a partnership or beneficiaries of an estate or trust. However, section 702(a)(6) provides that each partner (including individuals or corporations) of a partnership must take into account separately its distributive share of the partnership's foreign taxes paid or accrued. In addition, under section 703(b)(3), the election under section 901 (whether to credit the foreign taxes) is made by each partner separately.

[74] 1971–1 C.B. 211.

foreign taxes paid by such foreign corporation. Accordingly, a general partner of a domestic general partnership is permitted to claim deemed-paid foreign tax credits with respect to a dividend distribution from the foreign corporation to the partnership.

However, in 1997, the Treasury Department issued final regulations under section 902, and the preamble to the regulations states that "[t]he final regulations do not resolve under what circumstances a domestic corporate partner may compute an amount of foreign taxes deemed paid with respect to dividends received from a foreign corporation by a partnership or other pass-through entity."[75] In recognition of the holding in Rev. Rul. 71–141, the preamble to the final regulations under section 902 states that a "domestic shareholder" for purposes of section 902 is a domestic corporation that "owns" the requisite voting stock in a foreign corporation rather than one that "owns directly" the voting stock. At the same time, the preamble states that the IRS is still considering under what other circumstances Rev. Rul. 71–141 should apply. Consequently, uncertainty remains regarding whether a domestic corporation owning ten percent or more of the voting stock of a foreign corporation through a partnership is entitled to a deemed-paid foreign tax credit (other than through a domestic general partnership).

REASONS FOR CHANGE

The Committee believes that a clarification is appropriate regarding the ability of a domestic corporation owning ten percent or more of the voting stock of a foreign corporation through a partnership to claim a deemed-paid foreign tax credit.

EXPLANATION OF PROVISION

The provision clarifies that a domestic corporation is entitled to claim deemed-paid foreign tax credits with respect to a foreign corporation that is held indirectly through a foreign or domestic partnership, provided that the domestic corporation owns (indirectly through the partnership) ten percent or more of the foreign corporation's voting stock. No inference is intended as to the treatment of such deemed-paid foreign tax credits under present law. The provision also clarifies that both individual and corporate partners (or estate or trust beneficiaries) may claim direct foreign tax credits with respect to their proportionate shares of taxes paid or accrued by a partnership (or estate or trust).

EFFECTIVE DATE

The provision applies to taxes of foreign corporations for taxable years of such corporations beginning after the date of enactment.

6. Clarification of treatment of certain transfers of intangible property (sec. 1086 of the bill and sec. 367(d) of the Code)

PRESENT LAW

In the case of transfers of intangible property to foreign corporations by means of contributions and certain other nonrecognition transactions, special rules apply that are designed to mitigate the

[75] T.D. 8708, 1997–1 C.B. 137.

tax avoidance that may arise from shifting the income attributable to intangible property offshore. Under section 367(d), the outbound transfer of intangible property is treated as a sale of the intangible for a stream of contingent payments. The amounts of these deemed payments must be commensurate with the income attributable to the intangible. The deemed payments are included in gross income of the U.S. transferor as ordinary income, and the earnings and profits of the foreign corporation to which the intangible was transferred are reduced by such amounts.

The Taxpayer Relief Act of 1997 repealed a rule of prior law that treated all such deemed payments as giving rise to U.S.-source income. Because the foreign tax credit is generally limited to the U.S. tax imposed on foreign-source income, the prior-law rule reduced the taxpayer's ability to claim foreign tax credits. As a result of the repeal of the rule, the source of payments deemed received under section 367(d) is determined under general sourcing rules. These rules treat income from sales of intangible property for contingent payments the same as royalties, with the result that the deemed payments may give rise to foreign-source income.[76]

The Taxpayer Relief Act of 1997 did not address the characterization of the deemed payments for purposes of applying the foreign tax credit separate limitation categories.[77] If the deemed payments are treated like proceeds of a sale, then they could fall into the passive category; if the deemed payments are treated like royalties, then in many cases they could fall into the general category (under look-through rules applicable to payments of dividends, interest, rents, and royalties received from controlled foreign corporations).[78]

REASONS FOR CHANGE

The Committee believes that it is appropriate to treat payments under section 367(d) the same as royalties for purposes of applying the separate limitation categories of the foreign tax credit, and that this treatment should be effective for all transactions subject to the underlying provision of the 1997 Act.

EXPLANATION OF PROVISION

The provision specifies that deemed payments under section 367(d) are treated as royalties for purposes of applying the separate limitation categories of the foreign tax credit.

EFFECTIVE DATE

The provision is effective for amounts treated as received on or after August 5, 1997 (the effective date of the relevant provision of the Taxpayer Relief Act of 1997).

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[76] Secs. 865(d), 862(a).
[77] Sec. 904(d).
[78] Sec. 904(d)(3).

7. United States property not to include certain assets acquired by dealers in ordinary course of trade or business (sec. 1087 of the bill and sec. 956 of the Code)

PRESENT LAW

In general, the subpart F rules (secs. 951–964) require U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation ("U.S. 10-percent shareholders") to include in taxable income their pro rata shares of certain income of the controlled foreign corporation (referred to as "subpart F income") when such income is earned, whether or not the earnings are distributed currently to the shareholders. In addition, the U.S. 10-percent shareholders of a controlled foreign corporation are subject to U.S. tax on their pro rata shares of the controlled foreign corporation's earnings to the extent invested by the controlled foreign corporation in certain U.S. property in a taxable year (sec. 951(a)(1)(B)).

A shareholder's income inclusion with respect to a controlled foreign corporation's investment in U.S. property for a taxable year is based on the controlled foreign corporation's average investment in U.S. property for such year. For this purpose, the U.S. property held (directly or indirectly) by the controlled foreign corporation must be measured as of the close of each quarter in the taxable year (sec. 956(a)). The amount taken into account with respect to any property is the property's adjusted basis as determined for purposes of reporting the controlled foreign corporation's earnings and profits, reduced by any liability to which the property is subject. The amount determined for inclusion in each taxable year is the shareholder's pro rata share of an amount equal to the lesser of: (1) the controlled foreign corporation's average investment in U.S. property as of the end of each quarter of such taxable year, to the extent that such investment exceeds the foreign corporation's earnings and profits that were previously taxed on that basis; or (2) the controlled foreign corporation's current or accumulated earnings and profits (but not including a deficit), reduced by distributions during the year and by earnings that have been taxed previously as earnings invested in U.S. property (secs. 956 and 959). An income inclusion is required only to the extent that the amount so calculated exceeds the amount of the controlled foreign corporation's earnings that have been previously taxed as subpart F income (secs. 951(a)(1)(B) and 959).

For purposes of section 956, U.S. property generally is defined to include tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person, and certain intangible assets including a patent or copyright, an invention, model or design, a secret formula or process or similar property right which is acquired or developed by the controlled foreign corporation for use in the United States (sec. 956(c)(1)).

Specified exceptions from the definition of U.S. property are provided for: (1) obligations of the United States, money, or deposits with persons carrying on the banking business; (2) certain export property; (3) certain trade or business obligations; (4) aircraft, railroad rolling stock, vessels, motor vehicles or containers used in transportation in foreign commerce and used predominantly outside of the United States; (5) certain insurance company reserves and unearned premiums related to insurance of foreign risks; (6)

stock or debt of certain unrelated U.S. corporations; (7) moveable property (other than a vessel or aircraft) used for the purpose of exploring, developing, or certain other activities in connection with the ocean waters of the U.S. Continental Shelf; (8) an amount of assets equal to the controlled foreign corporation's accumulated earnings and profits attributable to income effectively connected with a U.S. trade or business; (9) property (to the extent provided in regulations) held by a foreign sales corporation and related to its export activities; (10) certain deposits or receipts of collateral or margin by a securities or commodities dealer, if such deposit is made or received on commercial terms in the ordinary course of the dealer's business as a securities or commodities dealer; and (11) certain repurchase and reverse repurchase agreement transactions entered into by or with a dealer in securities or commodities in the ordinary course of its business as a securities or commodities dealer (sec. 956(c)(2)).

REASONS FOR CHANGE

The Committee believes that the acquisition of securities by a controlled foreign corporation in the ordinary course of its business as a securities dealer generally should not give rise to an income inclusion as an investment in U.S. property under the provisions of subpart F.

EXPLANATION OF PROVISION

The provision adds a new exception from the definition of U.S. property for determining current income inclusion by a U.S. 10-percent shareholder with respect to an investment in U.S. property by a controlled foreign corporation. The exception generally applies to securities acquired and held by a controlled foreign corporation in the ordinary course of its trade or business as a dealer in securities. The exception applies only if the controlled foreign corporation dealer: (1) accounts for the securities as securities held primarily for sale to customers in the ordinary course of business; and (2) disposes of such securities (or such securities mature while being held by the dealer) within a period consistent with the holding of securities for sale to customers in the ordinary course of business.

EFFECTIVE DATE

The provision is effective for taxable years of foreign corporations beginning after December 31, 2004, and for taxable years of United States shareholders with or within which such taxable years of foreign corporations end.

8. Election not to use average exchange rate for foreign tax paid other than in functional currency (sec. 1088 of the bill and sec. 986 of the Code)

PRESENT LAW

For taxpayers that take foreign income taxes into account when accrued, present law provides that the amount of the foreign tax credit generally is determined by translating the amount of foreign taxes paid in foreign currencies into a U.S. dollar amount at the average exchange rate for the taxable year to which such taxes relate.[79] This rule applies to foreign taxes paid directly by U.S. taxpayers, which taxes are creditable in the year paid or accrued, and to foreign taxes paid by foreign corporations that are deemed paid by a U.S. corporation that is a shareholder of the foreign corporation, and hence creditable in the year that the U.S. corporation receives a dividend or has an income inclusion from the foreign corporation. This rule does not apply to any foreign income tax: (1) that is paid after the date that is two years after the close of the taxable year to which such taxes relate; (2) of an accrual-basis taxpayer that is actually paid in a taxable year prior to the year to which the tax relates; or (3) that is denominated in an inflationary currency (as defined by regulations).

Foreign taxes that are not eligible for translation at the average exchange rate generally are translated into U.S. dollar amounts using the exchange rates as of the time such taxes are paid. However, the Secretary is authorized to issue regulations that would allow foreign tax payments to be translated into U.S. dollar amounts using an average exchange rate for a specified period.[80]

REASONS FOR CHANGE

The Committee believes that taxpayers generally should be permitted to elect whether to translate foreign income tax payments using an average exchange rate the taxable year or the exchange rate when the taxes are paid, provided the elected method continues to be applied consistently unless revoked with the consent of the Treasury Secretary.

EXPLANATION OF PROVISION

For taxpayers that are required under present law to translate foreign income tax payments at the average exchange rate, the provision provides an election to translate such taxes into U.S. dollar amounts using the exchange rates as of the time such taxes are paid, provided the foreign income taxes are denominated in a currency other than the taxpayer's functional currency.[81] Any election under the provision applies to the taxable year for which the election is made and to all subsequent taxable years unless revoked with the consent of the Secretary. The provision authorizes the Secretary to issue regulations that apply the election to foreign income taxes attributable to a qualified business unit.

EFFECTIVE DATE

The provision is effective with respect to taxable years beginning after December 31, 2004.

9. Repeal of withholding tax on dividends from certain foreign corporations (sec. 1089 of the bill and sec. 871 of the Code)

PRESENT LAW

Nonresident individuals who are not U.S. citizens and foreign corporations (collectively, foreign persons) are subject to U.S. tax on

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[79] Sec. 986(a)(1).
[80] Sec. 986(a)(2).
[81] Electing taxpayers translate foreign income tax payments pursuant to the same present-law that apply to taxpayers that are required to translate foreign income taxes using the exchange rates as of the time such taxes are paid.

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 (secs. 871(b) and 882). Foreign persons also are subject to a 30-percent gross basis tax, collected by withholding, on certain U.S.-source passive income (e.g., interest and dividends) 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.

In general, dividends paid by a domestic corporation are treated as being from U.S. sources and dividends paid by a foreign corporation are treated as being from foreign sources. Thus, dividends paid by foreign corporations to foreign persons generally are not subject to withholding tax because such income generally is treated as foreign-source income.

An exception from this general rule applies in the case of dividends paid by certain foreign corporations. If a foreign corporation derives 25 percent or more of its gross income as income effectively connected with a U.S. trade or business for the three-year period ending with the close of the taxable year preceding the declaration of a dividend, then a portion of any dividend paid by the foreign corporation to its shareholders will be treated as U.S.-source income and, in the case of dividends paid to foreign shareholders, will be subject to the 30-percent withholding tax (sec. 861(a)(2)(B)). This rule is sometimes referred to as the "secondary withholding tax." The portion of the dividend treated as U.S.-source income is equal to the ratio of the gross income of the foreign corporation that was effectively connected with its U.S. trade or business over the total gross income of the foreign corporation during the three-year period ending with the close of the preceding taxable year. The U.S.-source portion of the dividend paid by the foreign corporation to its foreign shareholders is subject to the 30-percent withholding tax.

Under the branch profits tax provisions, the United States taxes foreign corporations engaged in a U.S. trade or business on amounts of U.S. earnings and profits that are shifted out of the U.S. branch of the foreign corporation. The branch profits tax is comparable to the second-level taxes imposed on dividends paid by a domestic corporation to its foreign shareholders. The branch profits tax is 30 percent of the foreign corporation's "dividend equivalent amount," which 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 (secs. 884(a) and (b)).

If a foreign corporation is subject to the branch profits tax, then no secondary withholding tax is imposed on dividends paid by the foreign corporation to its shareholders (sec. 884(e)(3)(A)). If a foreign corporation is a qualified resident of a tax treaty country and claims an exemption from the branch profits tax pursuant to the treaty, the secondary withholding tax could apply with respect to dividends it pays to its shareholders. Several tax treaties (including treaties that prevent imposition of the branch profits tax), however, exempt dividends paid by the foreign corporation from the secondary withholding tax.

REASONS FOR CHANGE

The Committee observes that the secondary withholding tax with respect to dividends paid by certain foreign corporations has been largely superseded by the branch profits tax and applicable income tax treaties. Accordingly, the Committee believes that the tax should be repealed in the interest of simplification.

EXPLANATION OF PROVISION

The provision eliminates the secondary withholding tax with respect to dividends paid by certain foreign corporations.

EFFECTIVE DATE

The provision is effective for payments made after December 31, 2004.

10. Provide equal treatment for interest paid by foreign partnerships and foreign corporations (sec. 1090 of the bill and sec. 861 of the Code)

PRESENT LAW

In general, interest income from bonds, notes or other interest-bearing obligations of noncorporate U.S. residents or domestic corporations is treated as U.S.-source income.[82] Other interest (e.g., interest on obligations of foreign corporations and foreign partnerships) generally is treated as foreign-source income. However, Treasury regulations provide that a foreign partnership is a U.S. resident for purposes of this rule if at any time during its taxable year it is engaged in a trade or business in the United States.[83] Therefore, any interest received from such a foreign partnership is U.S.-source income.

Notwithstanding the general rule described above, in the case of a foreign corporation engaged in a U.S. trade or business (or having gross income that is treated as effectively connected with the conduct of a U.S. trade or business), interest paid by such U.S. trade or business is treated as if it were paid by a domestic corporation (i.e., such interest is treated as U.S.-source income).[84]

REASONS FOR CHANGE

The Committee believes that the determination of the source of interest income received from a foreign partnership or foreign corporation should be consistent. The Committee believes that interest payments from a foreign partnership engaged in a trade or business in the United States should be sourced in the same manner as interest payments from a foreign corporation engaged in a trade or business in the United States.

EXPLANATION OF PROVISION

The provision treats interest paid by foreign partnerships in a manner similar to the treatment of interest paid by foreign corporations. Thus, interest paid by a foreign partnership is treated as U.S.-source income only if the interest is paid by a U.S. trade

[82] Sec. 861(a)(1).
[83] Treas. Reg. sec. 1.861–2(a)(2).
[84] Sec. 884(f)(1).

or business conducted by the partnership or is allocable to income that is treated as effectively connected with the conduct of a U.S. trade or business. The provision applies only to foreign partnerships that are principally owned by foreign persons. For this purpose, a foreign partnership is principally owned by foreign persons if, in the aggregate, U.S. citizens, resident aliens and domestic corporations do not own, directly or indirectly, 20 percent (or more) of the capital or profits interests in the partnership.

EFFECTIVE DATE

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

11. Treatment of certain dividends of regulated investment companies (sec. 1091 of the bill and secs. 871 and 881 of the Code)

PRESENT LAW

Regulated investment companies

A regulated investment company ("RIC") is a domestic corporation that, at all times during the taxable year, is registered under the Investment Company Act of 1940 as a management company or as a unit investment trust, or has elected to be treated as a business development company under that Act (sec. 851(a)).

In addition, to qualify as a RIC, a corporation must elect such status and must satisfy certain tests (sec. 851(b)). These tests include a requirement that the corporation derive at least 90 percent of its gross income from dividends, interest, payments with respect to certain securities loans, and gains on the sale or other disposition of stock or securities or foreign currencies, or other income derived with respect to its business of investment in such stock, securities, or currencies.

Generally, a RIC pays no income tax because it is permitted to deduct dividends paid to its shareholders in computing its taxable income. The amount of any distribution generally is not considered as a dividend for purposes of computing the dividends paid deduction unless the distribution is pro rata, with no preference to any share of stock as compared with other shares of the same class (sec. 562(c)). For distributions by RICs to shareholders who made initial investments of at least $10,000,000, however, the distribution is not treated as non-pro rata or preferential solely by reason of an increase in the distribution due to reductions in administrative expenses of the company.

A RIC generally may pass through to its shareholders the character of its long-term capital gains. It does this by designating a dividend it pays as a capital gain dividend to the extent that the RIC has net capital gain (i.e., net long-term capital gain over net short-term capital loss). These capital gain dividends are treated as long-term capital gain by the shareholders. A RIC generally also can pass through to its shareholders the character of tax-exempt interest from State and local bonds, but only if, at the close of each quarter of its taxable year, at least 50 percent of the value of the total assets of the RIC consists of these obligations. In this case, the RIC generally may designate a dividend it pays as an exempt-interest dividend to the extent that the RIC has tax-exempt interest income. These exempt-interest dividends are treated as interest excludable from gross income by the shareholders.

U.S. source investment income of foreign persons

In general

The United States generally imposes a flat 30-percent tax, collected by withholding, on the gross amount of U.S.-source investment income payments, such as interest, dividends, rents, royalties or similar types of income, to nonresident alien individuals and foreign corporations ("foreign persons") (secs. 871(a), 881, 1441, and 1442). Under treaties, the United States may reduce or eliminate such taxes. Even taking into account U.S. treaties, however, the tax on a dividend generally is not entirely eliminated. Instead, U.S.-source portfolio investment dividends received by foreign persons generally are subject to U.S. withholding tax at a rate of at least 15 percent.

Interest

Although payments of U.S.-source interest that is not effectively connected with a U.S. trade or business generally are subject to the 30-percent withholding tax, there are exceptions to that rule. For example, interest from certain deposits with banks and other financial institutions is exempt from tax (secs. 871(i)(2)(A) and 881(d)). Original issue discount on obligations maturing in 183 days or less from the date of original issue (without regard to the period held by the taxpayer) is also exempt from tax (sec. 871(g)). An additional exception is provided for certain interest paid on portfolio obligations (secs. 871(h) and 881(c)). "Portfolio interest" generally is defined as any U.S.-source interest (including original issue discount), not effectively connected with the conduct of a U.S. trade or business, (i) on an obligation that satisfies certain registration requirements or specified exceptions thereto (i.e., the obligation is "foreign targeted"), and (ii) that is not received by a 10–percent shareholder (secs. 871(h)(3) and 881(c)(3)). With respect to a registered obligation, a statement that the beneficial owner is not a U.S. person is required (secs. 871(h)(2), (5) and 881(c)(2)). This exception is not available for any interest received either by a bank on a loan extended in the ordinary course of its business (except in the case of interest paid on an obligation of the United States), or by a controlled foreign corporation from a related person (sec. 881(c)(3)). Moreover, this exception is not available for certain contingent interest payments (secs. 871(h)(4) and 881(c)(4)).

Capital gains

Foreign persons generally are not subject to U.S. tax on gain realized on the disposition of stock or securities issued by a U.S. person (other than a "U.S. real property holding corporation," as described below), unless the gain is effectively connected with the conduct of a trade or business in the United States. This exemption does not apply, however, if the foreign person is a nonresident alien individual present in the United States for a period or periods aggregating 183 days or more during the taxable year (sec. 871(a)(2)). A RIC may elect not to withhold on a distribution to a foreign person representing a capital gain dividend. (Treas. Reg. sec. 1.1441–3(c)(2)(D)).

Gain or loss of a foreign person from the disposition of a U.S. real property interest is subject to net basis tax as if the taxpayer were engaged in a trade or business within the United States and the gain or loss were effectively connected with such trade or business (sec. 897). In addition to an interest in real property located in the United States or the Virgin Islands, U.S. real property interests include (among other things) any interest in a domestic corporation unless the taxpayer establishes that the corporation was not, during a 5-year period ending on the date of the disposition of the interest, a U.S. real property holding corporation (which is defined generally to mean a corporation the fair market value of whose U.S. real property interests equals or exceeds 50 percent of the sum of the fair market values of its real property interests and any other of its assets used or held for use in a trade or business).

Estate taxation

Decedents who were citizens or residents of the United States are generally subject to Federal estate tax on all property, wherever situated.[85] Nonresidents who are not U.S. citizens, however, are subject to estate tax only on their property which is within the United States. Property within the United States generally includes debt obligations of U.S. persons, including the Federal government and State and local governments (sec. 2104(c)), but does not include either bank deposits or portfolio obligations, the interest on which would be exempt from U.S. income tax under section 871 (sec. 2105(b)). Stock owned and held by a nonresident who is not a U.S. citizen is treated as property within the United States only if the stock was issued by a domestic corporation (sec. 2104(a); Treas. Reg. sec. 20.2104–1(a)(5)).

Treaties may reduce U.S. taxation on transfers by estates of nonresident decedents who are not U.S. citizens. Under recent treaties, for example, U.S. tax may generally be eliminated except insofar as the property transferred includes U.S. real property or business property of a U.S. permanent establishment.

REASONS FOR CHANGE

Under present law, a disparity exists between foreign persons who invest directly in certain interest-bearing and other securities and a foreign person who invests in such securities indirectly through U.S. mutual funds. In general, certain amounts received by the direct foreign investor (or a foreign investor through a foreign fund) may be exempt from the U.S. gross-basis withholding tax. In contrast, distributions from a RIC generally are treated as dividends subject to the withholding tax, notwithstanding that the distributions may be attributable to amounts that otherwise could qualify for an exemption from withholding tax. U.S. financial institutions often respond to this disparate treatment by forming "mirror funds" outside the United States. The Committee believes that such disparate treatment should be eliminated so that U.S. finan-

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

cial institutions will be encouraged to form and operate their mutual funds within the United States rather than outside the United States.

Therefore, the Committee believes that, to the extent a RIC distributes to a foreign person a dividend attributable to amounts that would have been exempt from U.S. withholding tax had the foreign person received it directly (such as portfolio interest and capital gains, including short-term capital gains), such dividend similarly should be exempt from the U.S. gross-basis withholding tax. The Committee also believes that comparable treatment should be afforded for estate tax purposes to foreign persons who invest in certain assets through a RIC to the extent that such assets would not be subject to the estate tax if held directly.

EXPLANATION OF PROVISION

In general

Under the bill, a RIC that earns certain interest income that would not be subject to U.S. tax if earned by a foreign person directly may, to the extent of such income, designate a dividend it pays as derived from such interest income. A foreign person who is a shareholder in the RIC generally would treat such a dividend as exempt from gross-basis U.S. tax, as if the foreign person had earned the interest directly. Similarly, a RIC that earns an excess of net short-term capital gains over net long-term capital losses, which excess would not be subject to U.S. tax if earned by a foreign person, generally may, to the extent of such excess, designate a dividend it pays as derived from such excess. A foreign person who is a shareholder in the RIC generally would treat such a dividend as exempt from gross-basis U.S. tax, as if the foreign person had realized the excess directly. The bill also provides that the estate of a foreign decedent is exempt from U.S. estate tax on a transfer of stock in the RIC in the proportion that the assets held by the RIC are debt obligations, deposits, or other property that would generally be treated as situated outside the United States if held directly by the estate.

Interest-related dividends

Under the bill, a RIC may, under certain circumstances, designate all or a portion of a dividend as an "interest-related dividend," by written notice mailed to its shareholders not later than 60 days after the close of its taxable year. In addition, an interest-related dividend received by a foreign person generally is exempt from U.S. gross-basis tax under sections 871(a), 881, 1441 and 1442.

However, this exemption does not apply to a dividend on shares of RIC stock if the withholding agent does not receive a statement, similar to that required under the portfolio interest rules, that the beneficial owner of the shares is not a U.S. person. The exemption does not apply to a dividend paid to any person within a foreign country (or dividends addressed to, or for the account of, persons within such foreign country) with respect to which the Treasury Secretary has determined, under the portfolio interest rules, that exchange of information is inadequate to prevent evasion of U.S. income tax by U.S. persons.

In addition, the exemption generally does not apply to dividends paid to a controlled foreign corporation to the extent such dividends are attributable to income received by the RIC on a debt obligation of a person with respect to which the recipient of the dividend (i.e., the controlled foreign corporation) is a related person. Nor does the exemption generally apply to dividends to the extent such dividends are attributable to income (other than short-term original issue discount or bank deposit interest) received by the RIC on indebtedness issued by the RIC-dividend recipient or by any corporation or partnership with respect to which the recipient of the RIC dividend is a 10-percent shareholder. However, in these two circumstances the RIC remains exempt from its withholding obligation unless the RIC knows that the dividend recipient is such a controlled foreign corporation or 10-percent shareholder. To the extent that an interest-related dividend received by a controlled foreign corporation is attributable to interest income of the RIC that would be portfolio interest if received by a foreign corporation, the dividend is treated as portfolio interest for purposes of the de minimis rules, the high-tax exception, and the same country exceptions of subpart F (see sec. 881(c)(5)(A)).

The aggregate amount designated as interest-related dividends for the RIC's taxable year (including dividends so designated that are paid after the close of the taxable year but treated as paid during that year as described in section 855) generally is limited to the qualified net interest income of the RIC for the taxable year. The qualified net interest income of the RIC equals the excess of: (1) the amount of qualified interest income of the RIC; over (2) the amount of expenses of the RIC properly allocable to such interest income.

Qualified interest income of the RIC is equal to the sum of its U.S.-source income with respect to: (1) bank deposit interest; (2) short term original issue discount that is currently exempt from the gross-basis tax under section 871; (3) any interest (including amounts recognized as ordinary income in respect of original issue discount, market discount, or acquisition discount under the provisions of sections 1271–1288, and such other amounts as regulations may provide) on an obligation which is in registered form, unless it is earned on an obligation issued by a corporation or partnership in which the RIC is a 10-percent shareholder or is contingent interest not treated as portfolio interest under section 871(h)(4); and (4) any interest-related dividend from another RIC.

If the amount designated as an interest-related dividend is greater than the qualified net interest income described above, the portion of the distribution so designated which constitutes an interest-related dividend will be only that proportion of the amount so designated as the amount of the qualified net interest income bears to the amount so designated.

Short-term capital gain dividends

Under the bill, a RIC also may, under certain circumstances, designate all or a portion of a dividend as a "short-term capital gain dividend," by written notice mailed to its shareholders not later than 60 days after the close of its taxable year. For purposes of the U.S. gross-basis tax, a short-term capital gain dividend received by a foreign person generally is exempt from U.S. gross-basis tax under sections 871(a), 881, 1441 and 1442. This exemption does not apply to the extent that the foreign person is a nonresident alien individual present in the United States for a period or periods aggregating 183 days or more during the taxable year. However, in this circumstance the RIC remains exempt from its withholding obligation unless the RIC knows that the dividend recipient has been present in the United States for such period.

The aggregate amount qualified to be designated as short-term capital gain dividends for the RIC's taxable year (including dividends so designated that are paid after the close of the taxable year but treated as paid during that year as described in sec. 855) is equal to the excess of the RIC's net short-term capital gains over net long-term capital losses. The short-term capital gain includes short-term capital gain dividends from another RIC. As provided under present law for purposes of computing the amount of a capital gain dividend, the amount is determined (except in the case where an election under sec. 4982(e)(4) applies) without regard to any net capital loss or net short-term capital loss attributable to transactions after October 31 of the year. Instead, that loss is treated as arising on the first day of the next taxable year. To the extent provided in regulations, this rule also applies for purposes of computing the taxable income of the RIC.

In computing the amount of short-term capital gain dividends for the year, no reduction is made for the amount of expenses of the RIC allocable to such net gains. In addition, if the amount designated as short-term capital gain dividends is greater than the amount of qualified short-term capital gain, the portion of the distribution so designated which constitutes a short-term capital gain dividend is only that proportion of the amount so designated as the amount of the excess bears to the amount so designated.

As under present law for distributions from REITs, the bill provides that any distribution by a RIC to a foreign person shall, to the extent attributable to gains from sales or exchanges by the RIC of an asset that is considered a U.S. real property interest, be treated as gain recognized by the foreign person from the sale or exchange of a U.S. real property interest. The bill also extends the special rules for domestically-controlled REITs to domestically-controlled RICs.

Estate tax treatment

Under the bill, a portion of the stock in a RIC held by the estate of a nonresident decedent who is not a U.S. citizen is treated as property without the United States. The portion so treated is based upon the proportion of the assets held by the RIC at the end of the quarter immediately preceding the decedent's death (or such other time as the Secretary may designate in regulations) that are "qualifying assets". Qualifying assets for this purpose are bank deposits of the type that are exempt from gross-basis income tax, portfolio debt obligations, certain original issue discount obligations, debt obligations of a domestic corporation that are treated as giving rise to foreign source income, and other property not within the United States.

EFFECTIVE DATE

The provision generally applies to dividends with respect to taxable years of RICs beginning after the date of enactment. With respect to the treatment of a RIC for estate tax purposes, this provision applies to estates of decedents dying after the date of enactment. With respect to the treatment of RICs under section 897 (relating to U.S. real property interests), this provision is effective on the date of enactment.

I. Other Provisions

1. Special rules for livestock sold on account of weather-related conditions (sec. 1101 of the bill and secs. 1033 and 451 of the Code)

PRESENT LAW

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

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 principle residences damaged by a Presidentially declared disaster to three years and four years, respectively, after the close of the first taxable year in which gain is realized.

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

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

REASONS FOR CHANGE

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

EXPLANATION OF PROVISION

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

EFFECTIVE DATE

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

2. Payment of dividends on stock of cooperatives without reducing patronage dividends (sec. 1102 of the bill and sec. 1388 of the Code)

PRESENT LAW

Under present law, cooperatives generally are entitled to deduct or exclude amounts distributed as patronage dividends in accordance with Subchapter T of the Code. In general, patronage dividends are comprised of amounts that are paid to patrons (1) on the basis of the quantity or value of business done with or for patrons, (2) under a valid and enforceable obligation to pay such amounts that was in existence before the cooperative received the amounts paid, and (3) which are determined by reference to the net earnings of the cooperative from business done with or for patrons.

Treasury Regulations provide that net earnings are reduced by dividends paid on capital stock or other proprietary capital interests (referred to as the "dividend allocation rule").[86] The dividend allocation rule has been interpreted to require that such dividends be allocated between a cooperative's patronage and nonpatronage operations, with the amount allocated to the patronage operations reducing the net earnings available for the payment of patronage dividends.

REASONS FOR CHANGE

The Committee believes that the dividend allocation rule should not apply to the extent that the organizational documents of a cooperative provide that capital stock dividends do not reduce the amounts owed to patrons as patronage dividends. To the extent that capital stock dividends are in addition to amounts paid under the cooperative's organizational documents to patrons as patronage dividends, the Committee believes that those capital stock dividends are not being paid from earnings from patronage business.

In addition, the Committee believes cooperatives should be able to raise needed equity capital by issuing capital stock without dividends paid on such stock causing the cooperative to be taxed on a portion of its patronage income, and without preventing the cooperative from being treated as operating on a cooperative basis.

EXPLANATION OF PROVISION

The provision provides a special rule for dividends on capital stock of a cooperative. To the extent provided in organizational documents of the cooperative, dividends on capital stock do not reduce patronage income and do not prevent the cooperative from being treated as operating on a cooperative basis.

EFFECTIVE DATE

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

3. Add vaccines against hepatitis A to the list of taxable vaccines (sec. 1103 of the bill and sec. 4132 of the Code)

PRESENT LAW

A manufacturer's excise tax is imposed at the rate of 75 cents per dose[87] on the following vaccines routinely recommended for administration to children: diphtheria, pertussis, tetanus, measles, mumps, rubella, polio, HIB (haemophilus influenza type B), hepatitis B, varicella (chicken pox), rotavirus gastroenteritis, and streptococcus pneumoniae. The tax applied to any vaccine that is a combination of vaccine components equals 75 cents times the number of components in the combined vaccine.

Amounts equal to net revenues from this excise tax are deposited in the Vaccine Injury Compensation Trust Fund to finance compensation awards under the Federal Vaccine Injury Compensation Program for individuals who suffer certain injuries following administration of the taxable vaccines. This program provides a substitute Federal, "no fault" insurance system for the State-law tort and private liability insurance systems otherwise applicable to vac-

[86] Treas. Reg. sec. 1.1388–1(a)(1).
[87] sec. 4131

cine manufacturers. All persons immunized after September 30, 1988, with covered vaccines must pursue compensation under this Federal program before bringing civil tort actions under State law.

REASONS FOR CHANGE

The Committee is aware that the Centers for Disease Control and Prevention have recommended that children in 17 highly endemic States be inoculated with a hepatitis A vaccine. The population of children in the affected States exceeds 20 million. Several of the affected States mandate childhood vaccination against hepatitis A. The Committee is aware that the Advisory Commission on Childhood Vaccines has recommended that the vaccine excise tax be extended to cover vaccines against hepatitis A. For these reasons, the Committee believes it is appropriate to include vaccines against hepatitis A as part of the Vaccine Injury Compensation Program. Making the hepatitis A vaccine taxable is a first step.[88] In the unfortunate event of an injury related to this vaccine, families of injured children are eligible for the no-fault arbitration system established under the Vaccine Injury Compensation Program rather than going to Federal Court to seek compensatory redress.

EXPLANATION OF PROVISION

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

EFFECTIVE DATE

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

4. Expand human clinical trials expenses qualifying for the orphan drug tax credit (sec. 1104 of the bill and sec. 45C of the Code)

PRESENT LAW

Taxpayers may claim a 50-percent credit for expenses related to human clinical testing of drugs for the treatment of certain rare diseases and conditions, generally those that afflict less than 200,000 persons in the United States. Qualifying expenses are those paid or incurred by the taxpayer after the date on which the drug is designated as a potential treatment for a rare disease or disorder by the Food and Drug Administration ("FDA") in accordance with section 526 of the Federal Food, Drug, and Cosmetic Act.

REASONS FOR CHANGE

The Committee understands that approval for human clinical testing and designation as a potential treatment for a rare disease or disorder require separate reviews within the FDA. As a result, in some cases, a taxpayer may be permitted to begin human clinical testing prior to a drug being designated as a potential treatment for a rare disease or disorder. If the taxpayer delays human

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

clinical testing in order to obtain the benefits of the orphan drug tax credit, which currently may be claimed only for expenses incurred after the drug is designated as a potential treatment for a rare disease or disorder, valuable time will have been lost and Congress's original intent in enacting the orphan drug tax credit will have been partially thwarted. Because taxpayers generally seek designation of a potential drug as a treatment for a rare disease or disorder at the time they seek approval to clinically test such drugs, the Committee believes it is appropriate to make such expenses related to human clinical testing that the taxpayer incurs prior to FDA designation eligible for the orphan drug tax credit to help speed cures to such insidious diseases.

The Committee also observes that the staff of the Joint Committee on Taxation identifies present law with respect to the FDA review dates as a source of complexity and recommends that the definition of qualifying expenses be expanded to include those expenses related to human clinical testing incurred after the date on which the taxpayer files an application with the FDA for designation of the drug under section 526 of the Federal Food, Drug, and Cosmetic Act as a potential treatment for a rare disease or disorder.[89]

EXPLANATION OF PROVISION

The bill expands qualifying expenses to include those expenses related to human clinical testing incurred after the date on which the taxpayer files an application with the FDA for designation of the drug under section 526 of the Federal Food, Drug, and Cosmetic Act as a potential treatment for a rare disease or disorder. As under present law, the credit may only be claimed for such expenses related to drugs designated as a potential treatment for a rare disease or disorder by the FDA in accordance with section 526 of such Act.

EFFECTIVE DATE

The provision is effective for expenditures paid or incurred after the date of enactment.

5. Distributions from publicly traded partnerships treated as qualifying income of regulated investment company (sec. 1105 of the bill and secs. 851 and 469(k) of the Code)

PRESENT LAW

Treatment of regulated investment companies

A regulated investment company ("RIC") generally is treated as a conduit for Federal income tax purposes. In computing its taxable income, a RIC deducts dividends paid to its shareholders to achieve conduit treatment (sec. 852(b)). In order to qualify for conduit treatment, a RIC must be a domestic corporation that, at all times during the taxable year, is registered under the Investment Company Act of 1940 as a management company or as a unit investment trust, or has elected to be treated as a business development

[89] Joint Committee on Taxation, Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986 (JCS–3–01), volume II, April 2001, page 310

company under that Act (sec. 851(a)). In addition, the corporation must elect RIC status, and must satisfy certain other requirements (sec. 851(b)).

One of the RIC qualification requirements is that at least 90 percent of the RIC's gross income is derived from dividends, interest, payments with respect to securities loans, and gains from the sale or other disposition of stock or securities or foreign currencies, or other income (including but not limited to gains from options, futures, or forward contracts) derived with respect to its business of investing in such stock, securities, or currencies (sec. 851(b)(2)). Income derived from a partnership is treated as meeting this requirement only to the extent such income is attributable to items of income of the partnership that would meet the requirement if realized by the RIC in the same manner as realized by the partnership (the "look-through" rule for partnership income) (sec. 851(b)). Under present law, no distinction is made under this rule between a publicly traded partnership (that is treated as a partnership for Federal tax purposes) and any other partnership.

The RIC qualification rules include limitations on the ownership of assets and on the composition of the RIC's assets (sec. 851(b)(3)). Under the ownership limitation, at least 50 percent of the value of the RIC's total assets must be represented by cash, government securities and securities of other RICs, and other securities; however, in the case of such other securities, the RIC may invest no more than 5 percent of the value of the total assets of the RIC in the securities of any one issuer, and may hold no more than 10 percent of the outstanding voting securities of any one issuer. Under the limitation on the composition of the RIC's assets, no more than 25 percent of the value of the RIC's total assets may be invested in the securities of any one issuer (other than Government securities), or in securities of two or more controlled issuers in the same or similar trades or businesses. These limitations generally are applied at the end of each quarter (sec. 851(d)).

Treatment of publicly traded partnerships

Under present law, a publicly traded partnership is defined as a partnership, interests in which are traded on an established securities market, or are readily tradable on a secondary market (or the substantial equivalent thereof). In general, a publicly traded partnership is treated as a corporation (sec. 7704(a)), but an exception to corporate treatment is provided if 90 percent or more of its gross income is interest, dividends, real property rents, or certain other types of qualifying income (sec. 7704(c) and (d)).

A special rule for publicly traded partnerships applies under the passive loss rules. The passive loss rules limit deductions and credits from passive trade or business activities (sec. 469). Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income. Deductions and credits that are suspended under these rules are carried forward and treated as deductions and credits from passive activities in the next year. The suspended losses from a passive activity are allowed in full when a taxpayer disposes of his entire interest in the passive activity to an unrelated person. The special rule for publicly traded partnerships provides that the passive loss rules are applied separately with respect to items attributable to each publicly traded partnership (sec. 469(k)). Thus, income or loss from the publicly traded partnership is treated as separate from income or loss from other passive activities.

REASONS FOR CHANGE

The Committee understands that publicly traded partnerships generally are treated as corporations under rules enacted to address Congress' view that publicly traded partnerships resemble corporations in important respects.[90] Publicly traded partnerships with specified types of income are not treated as corporations, however, for the reason that if the income is from sources that are commonly considered to be passive investments, then there is less reason to treat the publicly traded partnership as a corporation.[91] The Committee understands that these types of publicly traded partnerships may have improved access to capital markets if their interests were permitted investments of mutual funds. Therefore, the bill treats publicly traded partnership interests as permitted investments for mutual funds (RICs).

Nevertheless, the Committee believes that permitting mutual funds to hold interests in a publicly traded partnership should not give rise to avoidance of unrelated business income tax or withholding of income tax that would apply if tax-exempt organizations or foreign persons held publicly traded partnership interests directly rather than through a mutual fund. Therefore, the Committee bill requires that present-law limitations on ownership and composition of assets of mutual funds apply to any investment in a publicly traded partnership by a mutual fund. The Committee believes that these limitations will serve to limit the use of mutual funds as conduits for avoidance of unrelated business income tax or withholding rules that would otherwise apply with respect to publicly traded partnership income.

EXPLANATION OF PROVISION

The provision modifies the 90 percent test with respect to income of a RIC to include income derived from an interest in certain publicly traded partnerships. The provision also modifies the lookthrough rule for partnership income of a RIC so that it applies only to income from a partnership other than such publicly traded partnerships.

The provision provides that the limitation on ownership and the limitation on composition of assets that apply to other investments of a RIC also apply to RIC investments in such publicly traded partnership interests.

A publicly traded partnership to which the provision applies is a publicly traded partnership described in section 7704(b) other than one that would satisfy the 90-percent gross income requirements for publicly traded partnerships if qualifying income included only income that is qualifying income described in section 851(b)(2)(A) for a RIC (i.e., income that is derived from dividends, interest, payments with respect to securities loans, and gains from the sale or other disposition of stock or securities or foreign currencies, or other income (including but not limited to gains from op-

[90] H.R. Rep. No. 100–391, pt. 2 of 2, at 1066 (1987).
[91] Id.

tions, futures, or forward contracts) derived with respect to its business of investing in such stock, securities, or currencies).

The provision provides that the special rule for publicly traded partnerships under the passive loss rules (requiring separate treatment) applies to a RIC holding an interest in such a publicly traded partnership, with respect to items attributable to the interest in the publicly traded partnership.

The Committee intends that the provision not be used to avoid tax on the partnership's income in the hands of the mutual fund shareholders that would be subject to tax or to withholding if they held the partnership interest directly. The Committee expects that guidance issued by the Treasury Department with respect to the provision will provide rules that carry out this intent.

EFFECTIVE DATE

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

6. REIT modification provisions (sec. 1106 of the bill 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.[92] In general, such amounts are for services rendered to tenants that are not "customarily furnished" in connection with the rental of real property.[93] 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.[94] 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.[95]

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-percent 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[96] 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.[97]

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[92] 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 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.

[93] 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.

[94] Section 856(d)(2)(B).

[95] Section 856(d)(8).

[96] 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.

[97] 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). In effect,

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.

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)[98] 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; and (ii) there is no convertibility (directly or indirectly) into stock.

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

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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).

[98] Section 1361(c)(5), without regard to paragraph (B)(iii) thereof.

a real estate investment trust[99] 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 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.[100]

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.

REASONS FOR CHANGE

The Committee believes that the "straight debt" definition of present law may not fully accommodate certain common REIT financing situations that should be permitted. The Committee wishes to clarify certain situations that should not cause loss of REIT status if the securities held by the REIT should happen to exceed 10 percent of the value of the borrower. Also, the Committee wishes to clarify the testing dates for purposes of the provision permitting certain rental income from a related party to be qualified rental income.

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[99] 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).

[100] If the excise tax applies, the item is not also reallocated back to the TRS under section 482.

The Committee also believes that is it desirable to provide express rules for testing a REIT's interest in partnership assets for certain "straight debt" purposes, and to modify certain other provisions, on a prospective basis.

EXPLANATION OF PROVISION

The provision makes several 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.

Straight debt securities

"Straight-debt" is still defined by reference to section 1361(c)(5), 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 provision eliminates the present law rule that allows a REIT to use the safe harbor when it loans money to a partnership in which it owns a 20 percent equity interest. The provision 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 (determined without regard to the new "look-through" rules).

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 provision 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.[101]

Customary services exception

The provision 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[102] 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 provision 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.

[101] The proposal does not modify any of the standards of section 482 as they apply to REITS and to taxable REIT subsidiaries.

[102] 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.

EFFECTIVE DATE

The provision 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-percent of gross income test; the new hedging definition; and the rule modifying the treatment of rents with respect to customary services.

7. Simplification of excise tax imposed on bows and arrows (sec. 1107 of the bill and sec. 4161 of the Code)

PRESENT LAW

The Code imposes an excise tax of 11 percent on the sale by a manufacturer, producer or importer of any bow with a draw weight of 10 pounds or more.[103] 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).[104] 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).[105]

REASONS FOR CHANGE

Under present law, foreign manufacturers and importers of arrows avoid the 12.4 percent excise tax paid by domestic manufacturers because the tax is placed on arrow components rather than finished arrows. As a result, arrows assembled outside of the United States have a price advantage over domestically manufactured arrows. The Committee believes it is appropriate to close this loophole. The Committee also believes that adjusting the minimum draw weight for taxable bows from 10 pounds to 30 pounds will better target the excise tax to actual hunting use by eliminating the excise tax on instructional ("youth") bows.

EXPLANATION OF PROVISION

The provision increases the draw weight for a taxable bow from 10 pounds or more to a peak draw weight of 30 pounds or more.[106] The provision also imposes an excise tax of 12 percent on arrows generally. An arrow for this purpose is defined as a taxable 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 provision provides that the 12-percent excise tax on arrows will not apply if the arrow contains an

[103] Sec. 4161(b)(1)(A).
[104] Sec. 4161(b)(2).
[105] Sec. 4161(b)(1)(B).
[106] Draw weight is the maximum force required to bring the bowstring to a full-draw position not less than 26¼-inches, measured from the pressure point of the hand grip to the nocking position on the bowstring.

arrow shaft upon which the tax imposed on arrow components has been paid. Finally, the provision subjects certain broadheads (a type of arrow point) to an excise tax equal to 11 percent of the sales price instead of 12.4 percent.

EFFECTIVE DATE

The provision is effective for articles sold by the manufacturer, producer, or importer after December 31, 2003.

8. Repeal excise tax on fishing tackle boxes (sec. 1108 of the bill and sec. 4162 of the Code)

PRESENT LAW

Under present law, a 10-percent manufacturer's excise tax is imposed on specified sport fishing equipment. Examples of taxable equipment include fishing rods and poles, fishing reels, artificial bait, fishing lures, line and hooks, and fishing tackle boxes. Revenues from the excise tax on sport fishing equipment are deposited in the Sport Fishing Account of the Aquatic Resources Trust Fund. Monies in the fund are spent, subject to an existing permanent appropriation, to support Federal-State sport fish enhancement and safety programs.

REASONS FOR CHANGE

The Committee observes that fishing "tackle boxes" are little different in design and appearance from "tool boxes," yet the former are subject to a Federal excise tax at a rate of 10 percent, while the latter are not subject to Federal excise tax. This excise tax can create a sufficiently large price difference that some fishermen will choose to use a "tool box" to hold their hooks and lures rather than a traditional "tackle box." The Committee finds that such a distortion of consumer choice places an inappropriate burden on the manufacturers and purchasers of traditional tackle boxes, particularly in comparison to the modest amount of revenue raised by the present-law provision, and that this burden warrants repeal of the tax. The Committee also believes that elimination of the excise tax on tackle boxes will provide some modest simplification of the tax system for both taxpayers and the Internal Revenue Service.

EXPLANATION OF PROVISION

The provision repeals the excise tax on fishing tackle boxes.

EFFECTIVE DATE

The provision is effective for articles sold by the manufacturer, producer, or importer after December 31, 2003.

9. Income tax credit for cost of carrying tax-paid distilled spirits in wholesale inventories (sec. 1109 of the bill 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.

REASONS FOR CHANGE

Under current law, wholesale importers of distilled spirits are not required to pay the Federal excise tax on imported spirits until after the product is removed from a bonded warehouse for sale to a retailer. In contrast, the tax on domestically produced spirits is included as part of the purchase price and passed on from the supplier to wholesaler. It is the Committee's understanding that in some instances, wholesalers can carry this tax-paid inventory for an average of 60 days before selling it to a retailer. The Committee believes it is appropriate to provide an income tax credit to approximate the interest charge—more commonly referred to as float—that results from carrying tax-paid distilled spirits in inventory.

EXPLANATION OF PROVISION

The provision creates a new income tax credit for eligible wholesale distributors of distilled spirits. An eligible wholesaler is any person who holds a permit under the Federal Alcohol Administration Act as a wholesaler 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 $22.83 per case of 12 750-milliliter bottles.

The credit only applies to domestically bottled distilled spirits [107] purchased directly from the bottler of such spirits. 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, 2004.

EFFECTIVE DATE

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

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

10. Capital gains treatment to apply to outright sales of timber by landowner (sec. 1110 of the bill and sec. 631(b) of the Code)

PRESENT LAW

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

REASONS FOR CHANGE

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

EXPLANATION OF PROVISION

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

EFFECTIVE DATE

The provision is effective for sales of timber after December 31, 2003.

11. Repeal of excise tax on sonar devices suitable for finding fish (sec. 1111 of the bill and secs. 4161 and 4162 of the Code)

PRESENT LAW

In general, the Code imposes a 10-percent tax on the sale by the manufacturer, producer, or importer of specified sport fishing equipment.[108] A three-percent rate, however, applies to the sale of electric outboard motors and sonar devices suitable for finding fish.[109] Further, the tax imposed on the sale of electric outboard

[108] Sec. 4161(a)(1).
[109] Sec. 4161(a)(2).

motors and sonar devices suitable for finding fish is limited to $30. A sonar device suitable for finding fish does not include any device that is a graph recorder, a digital type, a meter readout, a combination graph recorder or combination meter readout.[110]

Revenues from the excise tax on sport fishing equipment are deposited in the Sport Fishing Account of the Aquatic Resources Trust Fund. Monies in the fund are spent, subject to an existing permanent appropriation, to support Federal-State sport fish enhancement and safety programs.

REASONS FOR CHANGE

The Committee observes that the current exemption for certain forms of sonar devices has the effect of exempting almost all of the devices currently on the market. The Committee understands that only one form of sonar device is not exempt from the tax, those units utilizing light-emitting diode ("LED") display technology. The Committee understands that LED devices are not currently exempt from the tax because the technology was developed after the exemption for the other technologies was enacted. In the Committee's view, the application of the tax to LED display devices and not to devices performing the same function with a different technology, creates an unfair advantage for the exempt devices. Because most of the devices on the market already are exempt, the Committee believes it is appropriate to level the playing field by repealing the tax imposed on all sonar devices suitable for finding fish. The Committee believes this is a more suitable solution than exempting a device from the tax based on the type of technology used.

EXPLANATION OF PROVISION

The provision repeals the excise tax on all sonar devices suitable for finding fish.

EFFECTIVE DATE

The provision is effective articles sold by the manufacturer, producer, or importer after December 31, 2003.

12. Taxation of certain settlement funds (sec. 1112 of the bill and sec. 468B of the Code)

PRESENT LAW

The cleanup of hazardous waste sites is sometimes funded by environmental "settlement funds" or escrow accounts. These escrow accounts are established in consent decrees between the Environmental Protection Agency ("EPA") and the settling parties under the jurisdiction of a Federal district court. The EPA uses these accounts to resolve claims against private parties under Comprehensive Environmental Response, Compensation and Liability Act of 1980 ("CERCLA").

In general, section 468(B) provides that a payment to a designated settlement fund that extinguishes a tort liability of the taxpayer will result in a deduction to the taxpayer. A designated settlement fund means a fund which is established pursuant to a court order, extinguishes the taxpayer's tort liability, is managed

[110] Sec. 4162(b).

and controlled by persons unrelated to the taxpayer, and in which the taxpayer does not have a beneficial interest in the trust.

Generally, a designated or qualified settlement fund is taxed as a separate entity at the maximum trust rate on its modified income. Modified income is generally gross income less deductions for administrative costs and other incidental expenses incurred in connection with the operation of the settlement fund.

REASONS FOR CHANGE

The Committee believes that these environmental escrow accounts, established under court consent decrees, are essential for the EPA to resolve or satisfy claims under the Comprehensive Environmental Response, Compensation and Liability Act of 1980. Uncertainty as to the tax treatment of these settlement funds may prevent taxpayers from entering into prompt settlements with the EPA for the cleanup of Superfund hazardous waste sites and reduce the ultimate amount of funds available for the sites' cleanup. As these settlement funds are controlled by the government, the Committee believes it is appropriate to establish that these funds are to be treated as beneficially owned by the United States.

EXPLANATION OF PROVISION

The provision provides that certain settlement funds established in consent decrees for the sole purpose of resolving claims under CERCLA are to be treated as beneficially owned by the United States government and therefore, not subject to Federal income tax.

To qualify the settlement fund must be: (1) established pursuant to a consent decree entered by a judge of a United States District Court; (2) created for the receipt of settlement payments for the sole purpose of resolving or satisfying claims under CERCLA; (3) controlled (in terms of expenditures of contributions and earnings thereon) by the government or an agency or instrumentality thereof; and (4) upon termination, disbursed to the government or an agency or instrumentality thereof (e.g., the EPA).

EFFECTIVE DATE

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

13. Suspension of occupational taxes relating to distilled spirits, wine, and beer (sec. 1113 of the bill and sec. 5148 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 regime 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: [111]

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

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

The Code requires every wholesale or retail dealer in liquors, wine or beer to keep records of their transactions.[112] A delegate of the Secretary is authorized to inspect the records of any dealer during business hours.[113] There are penalties for failing to comply with the recordkeeping requirements.[114]

The Code limits the persons from whom dealers may purchase their liquor stock intended for resale. Under the Code, a dealer may only purchase from:

(1) A wholesale dealer in liquors who has paid the special occupational tax as such dealer to cover the place where such purchase is made; or

(2) A wholesale dealer in liquors who is exempt, at the place where such purchase is made, from payment of such tax under any provision of chapter 51 of the Code; or

(3) A person who is not required to pay special occupational tax as a wholesale dealer in liquors.[115]

Violation of this restriction is punishable by $1,000 fine, imprisonment of one year, or both.[116] A violation also makes the alcohol subject to seizure and forfeiture.[117]

REASONS FOR CHANGE

The special occupational tax is not a tax on alcoholic products but rather operates as a license fee on businesses. The Committee believes that this tax places an unfair burden on business owners. However, the Committee recognizes that the recordkeeping and registration authorities applicable to wholesalers and retailers engaged in such businesses are necessary enforcement tools to ensure the protection of the revenue arising from the excise taxes on these products. Thus, the Committee believes it appropriate to suspend the tax for a three-year period, while retaining present-law recordkeeping and registration requirements.

EXPLANATION OF PROVISION

The special occupational taxes on producers and marketers of alcoholic beverages are suspended for a three-year period, July 1, 2004 through June 30, 2007. Present law recordkeeping and registration requirements will continue to apply, notwithstanding the suspension of the special occupation taxes. In addition, during the suspension period, it shall be unlawful for any dealer to purchase

[112] Secs. 5114 and 5124.
[113] Sec. 5146.
[114] Sec. 5603.
[115] Sec. 5117. For example, purchases from a proprietor of a distilled spirits plant at his principal business office would be covered under item (2) since such a proprietor is not subject to the special occupational tax on account of sales at his principal business office (sec. 5113(a)). Purchases from a State-operated liquor store would be covered under item (3) (sec. 5113(b)).
[116] Sec. 5687.
[117] Sec. 7302.

distilled spirits for resale from any person other than a wholesale dealer in liquors who is subject to the recordkeeping requirements.

EFFECTIVE DATE

The provision is effective on the date of enactment.

TITLE II—PROVISIONS TO REDUCE TAX AVOIDANCE THROUGH CORPORATE EARNINGS STRIPPING AND EXPATRIATION

1. Reduction in potential for earnings stripping by further limiting deduction for interest on certain indebtedness (sec. 2001 of the bill and sec. 163(j) of the Code)

PRESENT LAW

Present law provides rules to limit the ability of U.S. corporations to reduce the U.S. tax on their U.S.-source income through earnings stripping transactions. Section 163(j) specifically addresses earnings stripping involving interest payments, by limiting the deductibility of interest paid to certain related parties ("disqualified interest"),[118] 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" (generally taxable income computed without regard to deductions for net interest expense, net operating losses, and depreciation, amortization, and depletion). Disallowed interest amounts can be carried forward indefinitely. In addition, excess limitation (i.e., any excess of the 50-percent limit over a company's net interest expense for a given year) can be carried forward three years.

REASONS FOR CHANGE

The Committee believes that it is necessary to tighten the earnings stripping rules in order to: (1) prevent the erosion of the U.S. tax base; (2) curtail corporate inversion transactions; and (3) decrease the competitive advantage that U.S. tax law conveys to foreign-based companies operating in the United States.

As a matter of practice, foreign-based corporate groups may lower their U.S. tax liability by having their U.S. subsidiaries make tax-deductible interest payments to their foreign parents or foreign affiliates. These interest payments reduce the foreign-based group's U.S. income that is taxed at 35 percent, but the interest income received by the foreign parent or foreign affiliate is often taxed at a very low rate or is not taxed at all. This practice reduces the amount of tax collected by the U.S. Treasury.

As a result of hearings on this issue, the Committee agrees with the Treasury Department that the ability of foreign-based companies to strip earnings out of the United States through the use of related-party interest payments provides the "juice," or immediate financial incentive, for a company to invert (reincorporate in a foreign country). The current U.S. earnings stripping rules and the significant tax advantages that they give foreign companies often leave U.S. companies with the undesirable choice of: (1) going out

[118] This interest also may include interest paid to unrelated parties in certain cases in which a related party guarantees the debt.

of business; (2) being bought by their foreign competitor that enjoys significant tax advantages that come with foreign ownership; or (3) inverting and operating under the same rules as the foreign competition.

The Committee also agrees with the findings of the Treasury Department that abusive earnings stripping opportunities are not limited to inverted companies, but rather are available to foreign-based companies generally. The current earnings stripping rules provide an advantage to foreign ownership over U.S. ownership, even in the United States. This advantage comes from the ability of foreign-based companies to "strip" or "export" their earnings from the United States, thus lowering their net cost of doing business in the United States relative to their U.S.-owned competitors. This advantage helps to explain why more than 78 percent of recent acquisitions between U.S. and foreign companies resulted in the foreign company acquiring the U.S. company.

While foreign investment in the United States is generally positive for the U.S. economy, the acquisition of U.S.-based companies by their foreign competition eventually results in the shift of jobs and research outside the United States. The Committee believes that U.S. companies deserve the opportunity to compete fairly against their foreign counterparts, especially in the United States. The Committee believes that tightening the current rules will provide a more level playing field on which U.S. companies can compete.

EXPLANATION OF PROVISION

The bill strengthens the earnings stripping provisions of section 163(j) in several respects. The debt-equity threshold is eliminated, carryovers of excess limitation are eliminated, and carryovers of disallowed interest are limited to 10 years.

In addition, the "adjusted taxable income" percentage threshold is lowered from 50 percent to 25 percent with respect to disqualified interest other than interest paid to unrelated parties on debt that is subject to a related-party guarantee (hereinafter referred to as "guaranteed debt").[119] Interest on guaranteed debt generally is not subject to the lowered threshold under the bill.[120] Disallowed interest is treated as interest on related-party debt to the extent thereof, and then as interest on guaranteed debt to the extent of any excess, for purposes of determining whether a deduction is allowable for such interest when carried forward to another taxable year.

The bill applies the different percentage thresholds to interest on related-party debt and interest on guaranteed debt by disallowing all disqualified interest, subject to a cap equal to the sum of "excess interest expense" and "excess related party interest expense." Excess interest expense is defined as the excess of net interest expense over 50 percent of adjusted taxable income. Excess related party interest expense is determined by subtracting 25 percent of

[119] This lowered threshold is phased in over two years. The threshold is 35 percent for a taxpayer's first taxable year beginning after 2003. The remainder of this discussion describes the provisions of the bill as fully phased-in.

[120] However, a taxpayer can make a one-time election to apply to a 30-percent threshold for purposes of determining the disallowance amount with respect to all of its disqualified interest, in which case no distinction is made between guaranteed debt and other debt. This election is not available to taxpayers involved in certain inversion transactions completed after 1996.

adjusted taxable income from the lesser of: (1) interest on related-party debt, or (2) net interest expense. In no event can the disallowance under the provision reduce the taxpayer's deduction for interest expense below the sum of: (1) the amount of interest income included in the gross income of the taxpayer, and (2) 25 percent of adjusted taxable income.

The following examples illustrate the basic operation of the bill:

Example 1.—Foreign Parent owns all the stock of U.S. Subsidiary ("U.S. Sub"). U.S. Sub has adjusted taxable income of $100, incurs interest expense of $70 on debt owed to Foreign Parent, incurs interest expense of $5 on non-guaranteed debt owed to unrelated third parties, and has no interest income or other interest expense. Under the bill, U.S. Sub has $70 of disqualified interest, the disallowance of which is subject to a cap equal to the sum of excess interest expense ($75 − $50 = $25) and excess related party interest expense ($70 − $25 = $45), or $70. Under the special disallowance limit, however, the provision cannot cause U.S. Sub's interest expense deduction to fall below $25. Thus, only $50 of interest is disallowed, and U.S. Sub can deduct its $5 of unrelated-party interest and $20 of its related-party interest.

Example 2.—Same as Example 1, except U.S. Sub incurs $25 of interest expense on non-guaranteed debt owed to unrelated third parties and $30 of interest expense on debt owed to Foreign Parent. Under the bill, U.S. Sub has $30 of disqualified interest, the disallowance of which is subject to a cap equal to the sum of excess interest expense ($55 − $50 = $5) and excess related party interest expense ($30 − $25 = $5), for $10 of disallowance.

Example 3.—Same as Example 2, except U.S. Sub also incurs $20 of interest expense on debt owed to unrelated third parties, subject to a guarantee by Foreign Parent. Under the bill, U.S. Sub has $30 + $20 = $50 of disqualified interest, the disallowance of which is subject to a cap equal to the sum of excess interest expense ($75 − $50 = $25) and excess related party interest expense ($30 − $25 = $5), for $30 of disallowance. This example illustrates how the bill effectively applies the present-law 50-percent threshold to interest on guaranteed debt, subjecting only interest on debt owed to related parties to the lowered threshold under the bill.

Example 4.—Same as Example 3, except U.S. Sub also earns $10 of interest income. Under the bill, U.S. Sub has $30 + $20 = $50 of disqualified interest, the disallowance of which is subject to a cap equal to the sum of excess interest expense ($65 − $50 = $15) and excess related party interest expense ($30 − $25 = $5), for $20 of disallowance.

Example 5.—Same as Example 4, except U.S. Sub earns $50 of interest income. Under the bill, U.S. Sub has $30 + $20 = $50 of disqualified interest, the disallowance of which is subject to a cap equal to the sum of excess interest expense ($25 − $50 = $0) and excess related party interest expense ($25 − $25 = $0), thus yielding no disallowance. Examples 4 and 5 illustrate the operation of the interest-income netting rules.

The bill continues the present-law rules in the case of taxable REIT subsidiaries.

EFFECTIVE DATE

The provision generally is effective for taxable years beginning after December 31, 2003. For purposes of applying the ten-year limit on carryovers of interest, amounts carried to any taxable year beginning after December 31, 2003 are treated as having been first disallowed for the most recent taxable year beginning before January 1, 2004. For taxpayers involved in certain inversion transactions completed after 1996, the provision is effective for taxable years ending after March 4, 2003, with a similar rule for carryovers. In addition, such taxpayers are subject to the fully reduced 25-percent threshold immediately, with no phase-in.

2. Tax treatment of expatriated entities (sec. 2002 of the bill and new sec. 7874 of the Code)

PRESENT LAW

Determination of corporate residence

The U.S. tax treatment of a multinational corporate group depends significantly on whether the 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.

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 (sections 951–964) and the passive foreign investment company rules (sections 1291–1298). 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, a U.S. corporation may reincorporate in a foreign jurisdiction and thereby replace the U.S. parent corporation of a multinational corporate group with a foreign parent corporation. These transactions are commonly referred to as inversion transactions. Inversion transactions may take many different forms, including stock inversions, asset inversions, and various combinations of and variations on the two. Most of the known transactions to date have been stock inversions. In one example of a stock inversion, a U.S. corporation forms a foreign corporation, which in turn forms a domestic merger subsidiary. The domestic merger subsidiary then merges into the U.S. corporation, with the U.S. corporation surviving, now as a subsidiary of the new foreign corporation. The U.S. corporation's shareholders receive shares of the foreign corporation and are treated as having exchanged their U.S. corporation shares for the foreign corporation shares. An asset inversion reaches a similar result, but through a direct merger of the top-tier U.S. corporation into a new foreign corporation, among other possible forms. An inversion transaction may be accompanied or followed by further restructuring of the corporate group. For example, in the case of a stock inversion, in order to remove income from foreign operations from the U.S. taxing jurisdiction, the U.S. corporation may transfer some or all of its foreign subsidiaries directly to the new foreign parent corporation or other related foreign corporations.

In addition to removing foreign operations from the U.S. taxing jurisdiction, the corporate group may derive further advantage from the inverted structure by reducing U.S. tax on U.S.-source income through various earnings stripping or other transactions. This may include earnings stripping through payment by a U.S. corporation of deductible amounts such as interest, royalties, rents, or management service fees to the new foreign parent or other foreign affiliates. In this respect, the post-inversion structure enables the group to employ the same tax-reduction strategies that are available to other multinational corporate groups with foreign parents and U.S. subsidiaries, subject to the same limitations (e.g., sections 163(j) and 482).

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

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

REASONS FOR CHANGE

The Committee believes that corporate inversion transactions are a symptom of larger problems with our current uncompetitive system for taxing U.S.-based global businesses and are also indicative of the unfair advantages that our tax laws convey to foreign ownership. The bill addresses the underlying problems with the U.S. system for taxing its global businesses and contains several provisions to remove the incentives for entering into inversion transactions. Imposing full U.S. tax on gains of companies undertaking an inversion transaction is one such provision that helps to remove the incentive to enter into an inversion transaction.

EXPLANATION OF PROVISION

The bill applies special tax rules to corporations that undertake certain defined inversion transactions. For this purpose, an 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 after March 4, 2003; (2) the former shareholders of the U.S. corporation hold (by reason of holding stock in the U.S. corporation) 60 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 conduct substantial business activities in the entity's country of incorporation compared to the total worldwide business activities of the expanded affiliated group.

In such a case, any applicable corporate-level "toll charges" for establishing the inverted structure are not offset by tax attributes such as net operating losses or foreign tax credits. Specifically, 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 the transfer or license of 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). This rule does not apply to certain transfers of inventory and similar property. These measures generally apply for a 10-year period following the inversion transaction.

In determining whether a transaction meets 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. Similarly, if a U.S. parent corporation converts an existing wholly owned U.S. subsidiary into a new wholly owned controlled foreign corporation, the stock of the new foreign corporation would be disregarded. Stock sold in a public offering related to the transaction also is disregarded for these purposes.

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 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 or a member of an expanded affiliated group. Similarly, the 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.

Under the provision, inversion transactions include certain partnership transactions. Specifically, the provision applies to transactions in which a foreign-incorporated entity acquires substantially all of the properties constituting a trade or business of a domestic partnership, if after the acquisition at least 60 percent of the stock of the entity is held by former partners of the partnership (by reason of holding their partnership interests), provided that the other terms of the basic definition are met. For purposes of applying this test, 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.

A transaction otherwise meeting the definition of an inversion transaction is not treated as an inversion transaction if, on or before March 4, 2003, the foreign-incorporated entity had acquired directly or indirectly more than half of the properties held directly or indirectly by the domestic corporation, or more than half of the properties constituting the partnership trade or business, as the case may be.

EFFECTIVE DATE

The provision applies to taxable years ending after March 4, 2003.

3. Excise tax on stock compensation of insiders in expatriated corporations (sec. 2003 of the bill and secs. 162(m), 275(a), and new sec. 4985 of the Code)

PRESENT LAW

The income taxation of a nonstatutory [121] 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.[122] Upon exercise of such an option, the excess of the fair market value of the stock purchased over the option price is generally included in the recipient's gross income as ordinary income in such taxable year.[123]

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

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

REASONS FOR CHANGE

The Committee is concerned that, while shareholders are generally required to recognize gain upon stock inversion transactions, executives holding stock options and certain stock-based compensation are not taxed upon such transactions. Since such executives are often instrumental in deciding whether to engage in inversion transactions, the Committee believes that, upon certain inversion transactions, it is appropriate to impose an excise tax on certain executives holding stock options and stock-based compensation. Because shareholders are taxed at the capital gains rate upon inversion transactions, the Committee believes that it is appropriate to impose the excise tax at an equivalent rate.

EXPLANATION OF PROVISION

Under the provision, specified holders of stock options and other stock-based compensation are subject to an excise tax upon certain inversion transactions. The provision imposes a 15-percent excise tax on the value of specified stock compensation held (directly or

[121] 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.

[122] 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 incomes as ordinary income in the first taxable year in which the option is either transferable or not subject to a substantial risk of forfeiture.

[123] Under section 83, such amount is includable in gross income in the first taxable year in which the rights to the stock are transferable or are not subject to substantial risk of forfeiture.

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 expatriation date. Specified stock compensation is treated as held for the benefit of a disqualified individual if such compensation is held by an entity, e.g., a partnership or trust, in which the individual, or a member of the individual's family, has an ownership interest.

A disqualified individual is any individual who, with respect to a corporation, is, at any time during the 12-month period beginning on the date which is six months before the expatriation 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,[124] 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)),[125] directors, and 10-percent-or-greater owners of private and publicly-held corporations.

The excise tax is imposed on a disqualified individual of an expatriated corporation (as previously defined in the bill) only if gain (if any) is recognized in whole or part by any shareholder by reason of a corporate inversion transaction previously defined in the bill.

Specified stock compensation subject to the excise tax includes any payment[126] (or right to payment) granted by the expatriated 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 a non-lapse restriction, 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 non-qualified deferred compensation that is treated as though it were invested in stock or stock options of the expatriating corporation (or member). For example, the provision applies to a disqualified individual's deferred compensation if company stock is one of the ac-

[124] 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.

[125] 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.

[126] 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.

tual or deemed investment options under the nonqualified deferred compensation plan.

Specified stock compensation includes a compensation arrangement that gives the disqualified individual an economic stake substantially similar to that of a corporate shareholder. Thus, the excise tax does not apply if 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 would be 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 would be 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 expatriation date, and to any specified stock compensation awarded in the six-month period beginning with the expatriation date. As a result, for example, if a corporation cancels outstanding options three months before the transaction and then reissues 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 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, tax-sheltered annuity, simplified employee pension, or SIMPLE. 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 expatriation date or to any stock acquired pursuant to such exercise, if income is recognized under section 83 on or before the expatriation date with respect to the stock acquired pursuant to such exercise. The excise tax also does not apply to any specified stock compensation that is exercised, sold, exchanged, distributed, cashed-out, or otherwise paid during such period in a transaction in which income, gain, or loss is recognized in full.

For specified stock compensation held on the expatriation 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 expatriation date is determined based on the value of the compensation on the day before such cancellation, while specified stock compensation granted after the expatriation 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 or 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 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, is the fair market value of the stock as of the date of the expatriation transaction. The value of any deferred compensation that can 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 expatriation transaction (or the date of cancellation or grant, if applicable). It is expected that the 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 and would be modified as necessary or appropriate to carry out the purposes of the provision. Pending the issuance of guidance, it is intended that taxpayers can rely on the revenue procedure issued under section 280G (except that the full remaining term must be used and recalculation is not permitted).

The excise tax also applies to any payment by the expatriated 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 Secretary issue guidance on determining when a payment is made in respect of the tax and that such guidance 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 Secretary is authorized to issue regulations as may be necessary or appropriate to carry out the purposes of the provision.

EFFECTIVE DATE

The provision is effective as of March 4, 2003, except that periods before March 4, 2003, are not taken into account in applying the excise tax to specified stock compensation held or cancelled during the six-month period before the expatriation date.

4. Reinsurance of U.S. risks in foreign jurisdictions (sec. 2004 of the bill and sec. 845(a) of the Code)

PRESENT LAW

In the case of a reinsurance agreement between two or more related persons, present law provides the 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.[127] 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.[128] In addition, the provision also permits such allocation, recharacterization, or other adjustments in a case in which one of the parties to a reinsurance agreement is, with respect to any contract covered by the agreement, in effect an agent of another party to the agreement, or a conduit between related persons.

REASONS FOR CHANGE

The Committee is concerned that reinsurance transactions are being used to allocate income, deductions, or other items inappropriately among U.S. and foreign related persons. The Committee is concerned that foreign related party reinsurance arrangements may be a technique for eroding the U.S. tax base. The Committee

[127] Sec. 845(a).
[128] See S. Rep. No. 97–494, 99th Cong., 2d Sess., 337 (1982) (describing provisions relating to the repeal of modified coinsurance provisions).

believes that the provision of present law permitting the Treasury Secretary to allocate or recharacterize items related to a reinsurance agreement should be applied to prevent misallocation, improper characterization, or to make any other adjustment in the case of such reinsurance transactions between U.S. and foreign related persons (or agents or conduits). The Committee also wishes to clarify that, in applying the authority with respect to reinsurance agreements, the amount, source or character of the items may be allocated, recharacterized or adjusted.

EXPLANATION OF PROVISION

The bill clarifies the rules of section 845, relating to authority for the 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 bill 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 [129] be exercised in a manner similar to the authority under section 482 for the Secretary to make adjustments between related parties. It is intended that this authority be applied in situations in which the related persons (or agents or conduits) are engaged in cross-border transactions that require allocation, recharacterization, or other adjustments in order to reflect the proper source, character or amount of the item or items. No inference is intended that present law does not provide this authority with respect to reinsurance agreements.

No regulations have been issued under section 845(a). It is expected that the 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 the date of enactment of the provision.

5. Modification of the tax treatment of individual expatriates (sec. 2005 of the bill and secs. 877, 2107, 2501 and 6039G of the Code)

PRESENT LAW

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

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

An individual who relinquishes his or her U.S. citizenship or terminates his or her U.S. residency[130] with a principal purpose of avoiding U.S. taxes is subject to an alternative method of income taxation for the 10 taxable years ending after the citizenship relinquishment or residency termination (the "alternative tax regime"). The alternative tax regime modifies the rules generally applicable to the taxation of nonresident noncitizens. For the 10-year period, the individual is subject to tax only on U.S.-source income at the rates applicable to U.S. citizens, rather than the rates applicable to nonresident noncitizens. However, for this purpose, U.S.-source income has a broader scope than it does for normal U.S. Federal tax purposes and includes, for example, gain from the sale of U.S. corporate stock or debt obligations. The alternative tax regime applies only if it results in a higher U.S. tax liability than the liability that would result if the individual were taxed as a nonresident noncitizen.

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

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

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

A U.S. citizen who relinquishes citizenship or a long-term resident who terminates residency is treated as having done so with a principal purpose of tax avoidance (and, thus, generally is subject to the alternative tax regime described above) if: (1) the individual's average annual U.S. Federal income tax liability for the five taxable years preceding citizenship relinquishment or residency termination exceeds $100,000; or (2) the individual's net worth on the date of citizenship relinquishment or residency termination equals or exceeds $500,000. These amounts are adjusted annually for inflation.[131] Certain categories of individuals may avoid being deemed to have a tax avoidance purpose for relinquishing citizenship or terminating residency by submitting a ruling request to the IRS regarding whether the individual relinquished citizenship or terminated residency principally for tax reasons.

Under present law, the Immigration and Nationality Act governs the determination of when a U.S. citizen is treated for U.S. Federal tax purposes as having relinquished citizenship. Similarly, an individual's U.S. residency is considered terminated for U.S. Federal tax purposes when the individual ceases to be a lawful permanent resident under the immigration laws (or is treated as a resident of another country under a tax treaty and does not waive the benefits of such treaty). In view of this reliance on immigration-law status, it is possible in many instances for a U.S. citizen or resident to convert his or her Federal tax status to that of a nonresident noncitizen without notifying the IRS.

Individuals subject to the alternative tax regime are required to provide certain tax information, including tax identification numbers, upon relinquishment of citizenship or termination of residency (on IRS Form 8854, Expatriation Initial Information Statement). In the case of an individual with a net worth of at least $500,000, the individual also must provide detailed information about the individual's assets and liabilities. The penalty for failure to provide the required tax information is the greater of $1,000 or five percent of the tax imposed under the alternative tax regime for the year.[132] In addition, the U.S. Department of State and other governmental agencies are required to provide this information to the IRS.

Former citizens and former long-term residents who are subject to the alternative tax regime also are required to file annual income tax returns, but only in the event that they owe U.S. Federal income tax. If a tax return is required, the former citizen or former long-term resident is required to provide the IRS with a statement setting forth (generally by category) all items of U.S.-source and foreign-source gross income, but no detailed information with respect to all assets held by the individual.

REASONS FOR CHANGE

The Committee believes there are several difficulties in administering the present-law alternative tax regime. One such difficulty is that the IRS is required to determine the subjective intent of taxpayers who relinquish citizenship or terminate residency. The

[131] The income tax liability and net worth thresholds under section 877(a)(2) for 2003 are $122,000 and $608,000, respectively. See Rev. Proc. 2002–70, 2002–46 I.R.B. 845.

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

present-law presumption of a tax-avoidance purpose in cases in which objective income tax liability or net worth thresholds are exceeded mitigates this problem to some extent. However, the present-law rules still require the IRS to make subjective determinations of intent in cases involving taxpayers who fall below these thresholds, as well for certain taxpayers who exceed these thresholds but are nevertheless allowed to seek a ruling from the IRS to the effect that they did not have a principal purpose of tax avoidance. The Committee believes that the replacement of the subjective determination of tax avoidance as a principal purpose for citizenship relinquishment or residency termination with objective rules will result in easier administration of the tax regime for individuals who relinquish their citizenship or terminate residency.

Similarly, present-law information-reporting and return-filing provisions do not provide the IRS with the information necessary to administer the alternative tax regime. Although individuals are required to file tax information statements upon the relinquishment of their citizenship or termination of their residency, difficulties have been encountered in enforcing this requirement. The Committee believes that the tax benefits of citizenship relinquishment or residency termination should be denied an individual until he or she provides the information necessary for the IRS to enforce the alternative tax regime. The Committee also believes an annual report requirement and a penalty for the failure to comply with such requirement are needed to provide the IRS with sufficient information to monitor the compliance of former U.S. citizens and long-term residents.

Individuals who relinquish citizenship or terminate residency for tax reasons often do not want to fully sever their ties with the United States; they hope to retain some of the benefits of citizenship or residency without being subject to the U.S. tax system as a U.S. citizen or resident. These individuals generally may continue to spend significant amounts of time in the United States following citizenship relinquishment or residency termination—approximately four months every year—without being treated as a U.S. resident. The Committee believes that provisions in the bill that impose full U.S. taxation if the individual is present in the United States for more than 30 days in a calendar year will substantially reduce the incentives to relinquish citizenship or terminate residency for individuals who desire to maintain significant ties to the United States.

With respect to the estate and gift tax rules, the Committee is concerned that present-law does not adequately address opportunities for the avoidance of tax on the value of assets held by a foreign corporation whose stock the individual transfers. Thus, the provision imposes gift tax under the alternative tax regime in the case of gifts of certain stock of a closely held foreign corporation.

EXPLANATION OF PROVISION

In general

The bill provides: (1) objective standards for determining whether former citizens or former long-term residents are subject to the alternative tax regime; (2) tax-based (instead of immigration-based) rules for determining when an individual is no longer a U.S. citizen or long-term resident for U.S. Federal tax purposes; (3) the imposition of full U.S. taxation for individuals who are subject to the alternative tax regime and who return to the United States for extended periods; (4) imposition of U.S. gift tax on gifts of stock of certain closely-held foreign corporations that hold U.S.-situated property; and (5) an annual return-filing requirement for individuals who are subject to the alternative tax regime, for each of the 10 years following citizenship relinquishment or residency termination.[133]

Objective rules for the alternative tax regime

The bill replaces the subjective determination of tax avoidance as a principal purpose for citizenship relinquishment or residency termination under present law with objective rules. Under the bill, a former citizen or former long-term resident would be subject to the alternative tax regime for a 10-year period following citizenship relinquishment or residency termination, unless the former citizen or former long-term resident: (1) establishes that his or her average annual net income tax liability for the five preceding years does not exceed $122,000 (adjusted for inflation after 2003) and his or her net worth does not exceed $2 million, or alternatively satisfies limited, objective exceptions for dual citizens and minors who have had no substantial contact with the United States; and (2) certifies under penalties of perjury that he or she has complied with all U.S. Federal tax obligations for the preceding five years and provides such evidence of compliance as the Secretary may require.

The monetary thresholds under the bill replace the present-law inquiry into the taxpayer's intent. In addition, the bill eliminates the present-law process of IRS ruling requests.

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

In order to be excepted from the application of the alternative tax regime under the bill, whether by reason of falling below the net worth and income tax liability thresholds or qualifying for the dual-citizen or minor exceptions, the former citizen or former long-term resident also is required to certify, under penalties of perjury, that he or she has complied with all U.S. Federal tax obligations for the five years preceding the relinquishment of citizenship or termination of residency and to provide such documentation as the Secretary may require evidencing such compliance (e.g., tax returns, proof of tax payments). Until such time, the individual remains subject to the alternative tax regime. It is intended that the IRS will continue to verify that the information submitted was accurate, and it is intended that the IRS will randomly audit such persons to assess compliance.

[133] These proposals reflect recommendations contained in Joint Committee on Taxation, Review of the Present Law Tax and Immigration Treatment of Relinquishment of Citizenship and Termination of Long-Term Residency, (JCS–2–03), February 2003.

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

Under the bill, an individual continues to be treated as a U.S. citizen or long-term resident for U.S. Federal tax purposes, including for purposes of section 7701(b)(10), until the individual: (1) gives notice of an expatriating act or termination of residency (with the requisite intent to relinquish citizenship or terminate residency) to the Secretary of State or the Secretary of Homeland Security, respectively; and (2) provides a statement in accordance with section 6039G.

Sanction for individuals subject to the individual tax regime who return to the United States for extended periods

The alternative tax regime does not apply to any individual for any taxable year during the 10-year period following citizenship relinquishment or residency termination if such individual is present in the United States for more than 30 days in the calendar year ending in such taxable year. Such individual is treated as a U.S. citizen or resident for such taxable year and therefore is taxed on his or her worldwide income.

Similarly, if an individual subject to the alternative tax regime is present in the United States for more than 30 days in any calendar year ending during the 10-year period following citizenship relinquishment or residency termination, and the individual dies during that year, he or she is treated as a U.S. resident, and the individual's worldwide estate is subject to U.S. estate tax. Likewise, if an individual subject to the alternative tax regime is present in the United States for more than 30 days in any year during the 10-year period following citizenship relinquishment or residency termination, the individual is subject to U.S. gift tax on any transfer of his or her worldwide assets by gift during that taxable year.

For purposes of these rules, an individual is treated as present in the United States on any day if such individual is physically present in the United States at any time during that day. The present-law exceptions from being treated as present in the United States for residency purposes[134] generally do not apply for this purpose. However, for individuals with certain ties to countries other than the United States[135] and individuals with minimal prior physical presence in the United States,[136] a day of physical presence in the United States is disregarded if the individual is performing services in the United States on such day for an unrelated employer (within the meaning of sections 267 and 707), who meets the requirements the Secretary may prescribe in regulations.

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[134] Sections 7701(b)(3)(D), 7701(b)(5) and 7701(b)(7)(B)–(D).

[135] An individual has such a relationship to a foreign country if the individual becomes a citizen or resident of the country in which (1) the individual becomes fully liable for income tax or (2) the individual was born, such individual's spouse was born, or either of the individual's parents was born.

[136] An individual has a minimal prior physical presence in the United States if the individual was physically present for no more than 30 days during each year in the ten-year period ending on the date of loss of United States citizenship or termination of residency. However, an individual is not treated as being present in the United States on a day if (1) the individual is a teacher or trainee, a student, a professional athlete in certain circumstances, or a foreign government-related individual or (2) the individual remained in the United States because of a medical condition that arose while the individual was in the United States. Section 7701(b)(3)(D)(ii).

No more than 30 days may be disregarded during any calendar year under this rule.

Imposition of gift tax with respect to stock of certain closely held foreign corporations

Gifts of stock of certain closely-held foreign corporations by a former citizen or former long-term resident who is subject to the alternative tax regime are subject to gift tax under this bill, if the gift is made within the 10-year period after citizenship relinquishment or residency termination. The gift tax rule applies if: (1) the former citizen or former long-term resident, before making the gift, directly or indirectly owns 10 percent or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation; and (2) directly or indirectly, is considered to own more than 50 percent of (a) the total combined voting power of all classes of stock entitled to vote in the foreign corporation, or (b) the total value of the stock of such corporation. If this stock ownership test is met, then taxable gifts of the former citizen or former long-term resident include that proportion of the fair market value of the foreign stock transferred by the individual, at the time of the gift, which the fair market value of any assets owned by such foreign corporation and situated in the United States (at the time of the gift) bears to the total fair market value of all assets owned by such foreign corporation (at the time of the gift).

This gift tax rule applies to a former citizen or former long-term resident who is subject to the alternative tax regime and who owns stock in a foreign corporation at the time of the gift, regardless of how such stock was acquired (e.g., whether issued originally to the donor, purchased, or received as a gift or bequest).

Annual return

The bill requires former citizens and former long-term residents to file an annual return for each year following citizenship relinquishment or residency termination in which they are subject to the alternative tax regime. The annual return is required even if no U.S. Federal income tax is due. The annual return requires certain information, including information on the permanent home of the individual, the individual's country of residence, the number of days the individual was present in the United States for the year, and detailed information about the individual's income and assets that are subject to the alternative tax regime. This requirement includes information relating to foreign stock potentially subject to the special estate tax rule of section 2107(b) and the gift tax rules of this bill.

If the individual fails to file the statement in a timely manner or fails correctly to include all the required information, the individual is required to pay a penalty of $5,000. The $5,000 penalty does not apply if it is shown that the failure is due to reasonable cause and not to willful neglect.

EFFECTIVE DATE

The provision applies to individuals who relinquish citizenship or terminate long-term residency after February 27, 2003.

6. Reporting of taxable mergers and acquisitions (sec. 2006 of the bill and new sec. 6043A of the Code)

PRESENT LAW

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

REASONS FOR CHANGE

The Committee believes that administration of the tax laws would be improved by greater information reporting with respect to taxable non-cash transactions, and that the Secretary's authority to require such enhanced reporting should be made explicit in the Code.

EXPLANATION OF PROVISION

Under the bill, if gain or loss is recognized in whole or in part by shareholders of a corporation by reason of a second corporation's acquisition of the stock or assets of the first corporation, then the acquiring corporation (or the acquired corporation, if so prescribed by the 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 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 (or the shareholder's nominee [137]) 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 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 is extended to failures to comply with the requirements set forth under this bill

[137] In the case of a nominee, the nominee must furnish the information to the shareholder in the manner prescribed by the Secretary.

EFFECTIVE DATE

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

7. Studies (sec. 2007 of the bill)

PRESENT LAW

Due to the variation in tax rates and tax systems among countries, a multinational enterprise, whether U.S.-based or foreign-based, may have an incentive to shift income, deductions, or tax credits in order to arrive at a reduced overall tax burden. Such a shifting of items could be accomplished by establishing artificial, non-arm's-length (i.e., non-market) prices for transactions between group members.

Under section 482, the Secretary is authorized to reallocate income, deductions, or credits between or among two or more organizations, trades, or businesses under common control if he determines that such a reallocation is necessary to prevent tax evasion or to clearly reflect income. Treasury regulations adopt the arm's length standard as the standard for determining whether such reallocations are appropriate. Thus, the regulations provide rules to identify the respective amounts of taxable income of the related parties that would have resulted if the parties had been uncontrolled parties dealing at arm's length. Transactions involving intangible property and certain services may present particular challenges to the administration of the arm's length standard, because the nature of these transactions may make it difficult or impossible to compare them with third-party market transactions.

Present law also provides rules to limit the ability of U.S. corporations to reduce the U.S. tax on their U.S.-source income through earnings stripping transactions. Section 163(j) specifically addresses earnings stripping involving interest payments, by limiting the deductibility of interest paid to certain related parties ("disqualified interest"),[138] 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" (generally taxable income computed without regard to deductions for net interest expense, net operating losses, and depreciation, amortization, and depletion). Disallowed interest amounts can be carried forward indefinitely. In addition, excess limitation (i.e., any excess of the 50-percent limit over a company's net interest expense for a given year) can be carried forward three years.

In addition to the statutory rules governing the taxation of foreign income of U.S. persons and U.S. income of foreign persons, bilateral income tax treaties limit the amount of income tax that may be imposed by one treaty partner on residents of the other treaty partner. For example, treaties often reduce or eliminate withholding taxes imposed by a treaty country on certain types of income (e.g., dividends, interest and royalties) paid to residents of the other treaty country. Treaties also contain provisions governing the creditability of taxes imposed by the treaty country in which income was earned in computing the amount of tax owed to the other

[138] This interest also may include interest paid to unrelated parties in certain cases in which a related party guarantees the debt.

country by its residents with respect to such income. Treaties further provide procedures under which inconsistent positions taken by the treaty countries with respect to a single item of income or deduction may be mutually resolved by the two countries.

REASONS FOR CHANGE

The Committee believes that it is important to evaluate the effectiveness of the current transfer pricing rules and compliance efforts with respect to related-party transactions to ensure that income is not being shifted outside of the United States. The Committee also believes that it is necessary to review current U.S. income tax treaties to identify any inappropriate reductions in withholding tax rates that may create opportunities for shifting income outside the United States. In addition, the Committee believes that the impact of the provisions of this bill on earnings stripping and inversion transactions should be studied.

EXPLANATION OF PROVISION

The bill requires the Secretary to conduct and submit to the Congress three studies. The first study will examine the effectiveness of the transfer pricing rules of section 482, with an emphasis on transactions involving intangible property. The second study will examine income tax treaties to which the United States is a party, with a view toward identifying any inappropriate reductions in withholding tax or opportunities for abuse that may exist. The third study will examine the impact of the provisions of this bill on earnings stripping and inversion transactions.

EFFECTIVE DATE

The tax treaty study required under the provision is due no later than June 30, 2004. The transfer pricing study required under the provision is due no later than June 30, 2004. The earnings stripping and inversions study required under the provision is due no later than December 31, 2005.

TITLE III—PROVISIONS RELATING TO TAX SHELTERS

A. TAXPAYER RELATED PROVISIONS

1. Penalty for failure to disclose reportable transactions (sec. 3001 of the bill and new sec. 6707A of the Code)

PRESENT LAW

Regulations under section 6011 require a taxpayer to disclose with its tax return certain information with respect to each "reportable transaction" in which the taxpayer participates.[139]

There are six categories of reportable transactions. The first category is any transaction that is the same as (or substantially simi-

[139] 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.

lar to)[140] 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").[141]

The second category is any transaction that is offered under conditions of confidentiality. In general, if a taxpayer's disclosure of the structure or tax aspects of the transaction is limited in any way by an express or implied understanding or agreement with or for the benefit of any person who makes or provides a statement, oral or written, as to the potential tax consequences that may result from the transaction, it is considered offered under conditions of confidentiality (whether or not the understanding is legally binding).[142]

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.[143]

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.[144]

The fifth category of reportable transactions refers to any transaction done by certain taxpayers[145] 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.[146]

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.[147]

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.[148]

[140] 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).

[141] Treas. Reg. sec. 1.6011–4(b)(2).

[142] Treas. Reg. sec. 1.6011–4(b)(3).

[143] Treas. Reg. sec. 1.6011–4(b)(4).

[144] 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.

[145] 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.

[146] 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.

[147] Treas. Reg. sec. 1.6011–4(b)(7).

[148] Section 6664(c) provides that a taxpayer can avoid the imposition of a section 6662 accuracy-related penalty in cases where the taxpayer can demonstrate that there was reasonable cause for the underpayment and that the taxpayer acted in good faith. On December 31, 2002, the Treasury Department and IRS issued proposed regulations under sections 6662 and 6664

REASONS FOR CHANGE

The Committee believes that the best way to combat tax shelters is to be aware of them. The Treasury Department, using the tools available, issued regulations requiring disclosure of certain transactions and requiring organizers and promoters of tax-engineered transactions to maintain customer lists and make these lists available to the IRS. Nevertheless, the Committee believes that additional legislation is needed to provide the Treasury Department with additional tools to assist its efforts to curtail abusive transactions. Moreover, the Committee believes that a penalty for failing to make the required disclosures, when the imposition of such penalty is not dependent on the tax treatment of the underlying transaction ultimately being sustained, will provide an additional incentive for taxpayers to satisfy their reporting obligations under the new disclosure provisions.

EXPLANATION OF PROVISION

In general

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

Transactions to be disclosed

The provision does not define the terms "listed transaction" [149] or "reportable transaction," nor does the provision explain the type of information that must be disclosed in order to avoid the imposition of a penalty. Rather, the provision authorizes the Treasury Department to define a "listed transaction" and a "reportable transaction" under section 6011.

Penalty rate

The penalty for failing to disclose a reportable transaction is $10,000 in the case of a natural person and $50,000 in any other case. The amount is increased to $100,000 and $200,000, respectively, if the failure is with respect to 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 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. Thus, a revenue agent, an Appeals officer, or any other IRS personnel cannot rescind the penalty. 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

(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.

[149] 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.

right to appeal a refusal to rescind a penalty.[150] 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 provision is effective for returns and statements the due date for which is after the date of enactment.

2. Modifications to the accuracy-related penalties for listed transactions and reportable transactions having a significant tax avoidance purpose (sec. 3002 of the bill and new sec. 6662A of the Code)

PRESENT LAW

The accuracy-related penalty applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of corporations), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.[151] The amount of any understatement generally is reduced by any portion attributable to an item if (1) the treatment of the item is or was 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.[152]

Special rules apply with respect to tax shelters.[153] 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.[154] 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.[155]

[150] This does not limit the ability of a taxpayer to challenge whether a penalty is appropriate (e.g., a taxpayer may litigate the issue of whether a transaction is a reportable transaction (and thus subject to the penalty if not disclosed) or not a reportable transaction (and thus not subject to the penalty)).
[151] Sec. 6662.
[152] Sec. 6662(d)(2)(B).
[153] Sec. 6662(d)(2)(C).
[154] Sec. 6664(c).
[155] Treas. Reg. sec. 1.6662–4(g)(4)(i)(B); Treas. Reg. sec. 1.6664–4(c).

REASONS FOR CHANGE

Because disclosure is so vital to combating abusive tax avoidance transactions, the Committee believes that taxpayers should be subject to a strict liability penalty on an understatement of tax that is attributable to non-disclosed listed transactions or non-disclosed reportable transactions that have a significant purpose of tax avoidance. Furthermore, in order to deter taxpayers from entering into tax avoidance transactions, the Committee believes that a more meaningful (but not a strict liability) accuracy-related penalty should apply to such transactions even when disclosed.

EXPLANATION OF PROVISION

In general

The provision modifies the present-law accuracy related penalty by replacing the rules applicable to tax shelters with a new accuracy-related penalty that applies to listed transactions and reportable transactions with a significant tax avoidance purpose (hereinafter referred to as a "reportable avoidance transaction").[156] The penalty rate and defenses available to avoid the penalty vary depending on whether the transaction was adequately disclosed.

Disclosed transactions

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

Undisclosed transactions

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

Determination of the understatement amount

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

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

tax return),[157] and (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item.

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

Strengthened reasonable cause exception

A penalty is not imposed under the provision with respect to any portion of an understatement if it shown that there was reasonable cause for such portion and the taxpayer acted in good faith. Such a showing requires (1) adequate disclosure of the facts affecting the transaction in accordance with the regulations under section 6011,[158] (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[159] and who participates in the organization, management, promotion or sale of the transaction or is related (within the meaning of section 267(b) or 707(b)(1)) to any person who so participates, (2) is compensated directly or indirectly[160] by a material advisor with respect to the transaction, (3) has a fee arrangement with respect to the transaction that is contingent on all or part of the intended tax benefits from the transaction being sustained, or (4) as

[157] 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.

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

[159] 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, managing, 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).

[160] 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.

determined under regulations prescribed by the Secretary, has a disqualifying financial interest with respect to the transaction.

Organization, management, promotion or sale of a transaction.— A material advisor is considered as participating in the "organization" of a transaction if the advisor performs acts relating to the development of the transaction. This may include, for example, preparing documents (1) establishing a structure used in connection with the transaction (such as a partnership agreement), (2) describing the transaction (such as an offering memorandum or other statement describing the transaction), or (3) relating to the registration of the transaction with any federal, state or local government body.[161] 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.

[161] 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).

3. Tax shelter exception to confidentiality privileges relating to taxpayer communications (sec. 3003 of the bill and sec. 7525 of the Code)

PRESENT LAW

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

REASONS FOR CHANGE

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

EXPLANATION OF PROVISION

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

EFFECTIVE DATE

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

4. Statute of limitations for unreported listed transactions (sec. 3004 of the bill and sec. 6501 of the Code)

PRESENT LAW

In general, the Code requires that taxes be assessed within three years[162] after the date a return is filed.[163] If there has been a substantial omission of items of gross income that totals 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.[164] 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.[165]

[162] Sec. 6501(a).
[163] 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)).
[164] Sec. 6501(e).
[165] Sec. 6501(c).

REASONS FOR CHANGE

The Committee has noted that some taxpayers and their advisors have been employing dilatory tactics and failing to cooperate with the IRS in an attempt to avoid liability because of the expiration of the statute of limitations. The Committee accordingly believes that it is appropriate to extend the statute of limitations for unreported listed transactions.

EXPLANATION OF PROVISION

The provision extends the statute of limitations with respect to a listed transaction if a taxpayer fails to include on any return or statement for any taxable year any information with respect to a listed transaction [166] which is required to be included (under section 6011) with such return or statement. The statute of limitations with respect to such a transaction will not expire before the date which is one year after the earlier of (1) the date on which the Secretary is furnished the information so required, or (2) the date that a material advisor (as defined in 6111) satisfies the list maintenance requirements (as defined by section 6112) with respect to a request by the Secretary. For example, if a taxpayer engaged in a transaction in 2005 that becomes a listed transaction in 2007 and the taxpayer fails to disclose such transaction in the manner required by Treasury regulations, then the transaction is subject to the extended statute of limitations.[167]

EFFECTIVE DATE

The provision is effective for taxable years with respect to which the period for assessing a deficiency did not expire before the date of enactment.

5. Disclosure of reportable transactions by material advisors (sec. 3005 of the bill and secs. 6111 and 6707 of the Code)

PRESENT LAW

Registration of tax shelter arrangements

An organizer of a tax shelter is required to register the shelter with the Secretary not later than the day on which the shelter is first offered for sale.[168] A "tax shelter" means any investment with respect to which the tax shelter ratio [169] 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)

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

[167] If the Treasury Department lists a transaction in a year subsequent to the year in which a taxpayer entered into such transaction and the taxpayer's tax return for the year the transaction was entered into is closed by the statute of limitations prior to the date the transaction became a listed transaction, this provision does not re-open the statute of limitations with respect to such transaction for such year. However, if the purported tax benefits of the transaction are recognized over multiple tax years, the provision's extension of the statute of limitations shall apply to such tax benefits in any subsequent tax year in which the statute of limitations had not closed prior to the date the transaction became a listed transaction.

[168] Sec. 6111(a).

[169] 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.

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 involving at least five investors).[170]

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.[171]

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,"[172] 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.[173] Certain exceptions are provided with respect to the second category of transactions.[174]

An arrangement is offered under conditions of confidentiality if: (1) an offeree has an understanding or agreement to limit the disclosure of the transaction or any significant tax features of the transaction; or (2) the promoter knows, or has reason to know that the offeree's use or disclosure of information relating to the transaction is limited in any other manner.[175]

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

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

REASONS FOR CHANGE

The Committee believes that providing a single, clear definition regarding the types of transactions that must be disclosed by tax-

[170] Sec. 6111(c).
[171] Sec. 6111(d).
[172] Treas. Reg. sec. 301.6111–2(b)(2).
[173] Treas. Reg. sec. 301.6111–2(b)(3).
[174] Treas. Reg. sec. 301.6111–2(b)(4).
[175] 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).
[176] Sec. 6707.

payers and material advisors, coupled with more meaningful penalties for failing to disclose such transactions, are necessary tools if the effort to curb the use of abusive tax avoidance transactions is to be effective.

EXPLANATION OF PROVISION

Disclosure of reportable transactions by material advisors

The provision repeals the present law rules with respect to registration of tax shelters. Instead, the provision requires each material advisor with respect to any reportable transaction (including any listed transaction)[177] to timely file an information return with the Secretary (in such form and manner as the Secretary may prescribe). The return must be filed on such date as specified by the Secretary.

The information return will include (1) information identifying and describing the transaction, (2) information describing any potential tax benefits expected to result from the transaction, and (3) such other information as the Secretary may prescribe. It is expected that the Secretary may seek from the material advisor the same type of information that the Secretary may request from a taxpayer in connection with a reportable transaction.[178]

A "material advisor" means any person (1) who provides material aid, assistance, or advice with respect to organizing, managing, 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) or such other amount as may be prescribed by the Secretary for such advice or assistance.

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

Penalty for failing to furnish information regarding reportable transactions

The provision repeals the present-law penalty for failure to register tax shelters. Instead, the provision imposes a penalty on any material advisor who fails to file an information return, or who files a false or incomplete information return, with respect to a reportable transaction (including a listed transaction).[179] 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 re-

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

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

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

spect 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.[180] All or part of the penalty may be rescinded only if 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. Thus, a revenue agent, an Appeals officer, or other IRS personnel cannot rescind the penalty. 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 provision requiring disclosure of reportable transactions by material advisors applies to transactions with respect to which material aid, assistance or advice is provided after the date of enactment.

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

6. Investor lists and modification of penalty for failure to maintain investor lists (secs. 3006 and 3007 of the bill and secs. 6112 and 6708 of the Code)

PRESENT LAW

Investor lists

Any organizer or seller of a potentially abusive tax shelter must maintain a list identifying each person who was sold an interest in any such tax shelter with respect to which registration was required under section 6111 (even though the particular party may not have been subject to confidentiality restrictions).[181] Recently issued regulations under section 6112 contain rules regarding the list maintenance requirements.[182] In general, the regulations apply to transactions that are potentially abusive tax shelters entered into, or acquired after, February 28, 2003.[183]

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.[184] A material advisor is de-

[180] 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.

[181] Sec. 6112.

[182] Treas. Reg. sec. 301–6112–1.

[183] 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.

[184] Treas. Reg. sec. 301.6112–1(c)(1).

fined as any person who is required to register the transaction under section 6111, or expects to receive a minimum fee of (1) $250,000 for a transaction that is a potentially abusive tax shelter if all participants are corporations, or (2) $50,000 for any other transaction that is a potentially abusive tax shelter.[185] 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).[186]

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.[187]

Penalty for failing to maintain investor lists

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

REASONS FOR CHANGE

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

EXPLANATION OF PROVISION

Investor lists

Each material advisor[188] with respect to a reportable transaction (including a listed transaction)[189] is required to maintain a list that (1) identifies each person with respect to whom the advisor acted as a material advisor with respect to the reportable transaction, and (2) contains other information as may be required by the Secretary. In addition, the provision authorizes (but does not require) the Secretary to prescribe regulations which provide that, in cases in which two or more persons are required to maintain the same list, only one person would be required to maintain the list.

The provision also clarifies that, for purposes of section 6112, the identity of any person is not privileged under the common law at-

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[185] Treas. Reg. sec. 301.6112–1(c)(2) and (3).

[186] Treas. Reg. sec. 301.6112–1(b).

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

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

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

torney-client privilege (or, consequently, the section 7525 federally authorized tax practitioner confidentiality provision).

Penalty for failing to maintain investor lists

The provision modifies the penalty for failing to maintain the required list by making it a time-sensitive penalty. Thus, a material advisor who is required to maintain an investor list and 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.[190]

EFFECTIVE DATE

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

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

The provision clarifying that the identity of any person is not privileged for purposes of section 6112 is effective as if included in the amendments made by section 142 of the Deficit Reduction Act of 1984.

7. Penalty on promoters of tax shelters (sec. 3008 of the bill and sec. 6700 of the Code)

PRESENT LAW

A penalty is imposed on any person who organizes, assists in the organization of, or participates in the sale of any interest in, a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if in connection with such activity the person makes or furnishes a qualifying false or fraudulent statement or a gross valuation overstatement.[191] 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.

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

[191] Sec. 6700.

REASONS FOR CHANGE

The Committee believes that the current law $1,000 penalty for tax shelter promoters is insufficient to deter tax shelter activities. The Committee believes that the increased penalties for tax shelter promoters are meaningful and will help deter the promotion of tax shelters.

EXPLANATION OF PROVISION

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

EFFECTIVE DATE

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

8. Modifications of substantial understatement penalty for nonreportable transactions (sec. 3009 of the bill and sec. 6662 of the Code)

PRESENT LAW

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).[192]

REASONS FOR CHANGE

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

EXPLANATION OF PROVISION

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

EFFECTIVE DATE

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

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

9. Modification of actions to enjoin certain conduct related to tax shelters and reportable transactions (sec. 3010 of the bill and sec. 7408 of the Code)

PRESENT LAW

The Code authorizes civil actions to enjoin any person from promoting abusive tax shelters or aiding or abetting the understatement of tax liability.[193]

REASONS FOR CHANGE

The Committee believes that expanding the authority to obtain injunctions against promoters and material advisors that (1) fail to file an information return with respect to a reportable transaction or (2) fail to maintain, or to timely furnish upon written request by the Secretary, a list of investors with respect to reportable transactions will discourage tax shelter activity and encourage compliance with the tax shelter disclosure requirements.

EXPLANATION OF PROVISION

The provision expands this rule so that injunctions may also be sought with respect to the requirements relating to the reporting of reportable transactions[194] and the keeping of lists of investors by material advisors.[195] Thus, under the provision, an injunction may be sought against a material advisor to enjoin the advisor from (1) failing to file an information return with respect 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.

10. Penalty on failure to report interests in foreign financial accounts (sec. 3011 of the bill and sec. 5321 of Title 31, United States Code)

PRESENT LAW

The Secretary 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.[196] 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 may impose a civil penalty on any person who willfully violates this reporting requirement. The civil penalty is

[193] Sec. 7408.
[194] Sec. 6707, as amended by other provisions of this bill.
[195] Sec. 6708, as amended by other provisions of this bill.
[196] 31 U.S.C. 5314.

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.[197] 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.[198]

On April 26, 2002, the Secretary submitted to the Congress a report on these reporting requirements.[199] This report, which was statutorily required,[200] 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 to the Congress by October 26, 2002.

REASONS FOR CHANGE

The Committee believes that imposing a new civil penalty for failure to report an interest in foreign financial accounts that applies (without regard to willfulness) will increase the reporting of foreign financial accounts.

EXPLANATION OF PROVISION

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

EFFECTIVE DATE

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

11. Regulation of individuals practicing before the Department of the Treasury (sec. 3012 of the bill and sec. 330 of Title 31, United States Code)

PRESENT LAW

The Secretary is authorized to regulate the practice of representatives of persons before the Department of the Treasury.[201] The Secretary is also authorized to suspend or disbar from practice before the Department a representative who is incompetent, who is disreputable, who violates the rules regulating practice before the Department, or who (with intent to defraud) willfully and knowingly misleads or threatens the person being represented (or a per-

[197] 31 U.S.C. 5321(a)(5).
[198] 31 U.S.C. 5322.
[199] 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.
[200] Sec. 361(b) of the USA PATRIOT Act of 2001 (Pub. L. 107–56).
[201] 31 U.S.C. 330.

son who may be represented). The rules promulgated by the Secretary pursuant to this provision are contained in Circular 230.

REASONS FOR CHANGE

The Committee believes that it is critical that the Secretary have the authority to censure tax advisors as well as to impose monetary sanctions against tax advisors because of the important role of tax advisors in our tax system. Use of these sanctions is expected to curb the participation of tax advisors in both tax shelter activity and any other activity that is contrary to Circular 230 standards.

EXPLANATION OF PROVISION

The provision makes two modifications to expand the sanctions that the Secretary may impose pursuant to these statutory provisions. First, the provision expressly permits censure as a sanction. Second, the provision permits the imposition of a monetary penalty as a sanction. If the representative is acting on behalf of an employer or other entity, the Secretary may impose a monetary penalty on the employer or other entity if it knew, or reasonably should have known, of the conduct. This monetary penalty on the employer or other entity may be imposed in addition to any monetary penalty imposed directly on the representative. These monetary penalties are not to exceed the gross income derived (or to be derived) from the conduct giving rise to the penalty. These monetary penalties may be in addition to, or in lieu of, any suspension, disbarment, or censure of such individual.

The provision also confirms the present-law authority of the Secretary to impose standards applicable to written advice with respect to an entity, plan, or arrangement that is of a type that the Secretary determines as having a potential for tax avoidance or evasion.

EFFECTIVE DATE

The modifications to expand the sanctions that the Secretary may impose are effective for actions taken after the date of enactment.

B. Other Provisions

1. Treatment of stripped interests in bond and preferred stock funds, etc. (sec. 3021 of the bill and secs. 305 and 1286 of the Code)

PRESENT LAW

Assignment of income in general

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

Common law has developed a rule (referred to as the "assignment of income" doctrine) that income may not be transferred without also transferring the underlying property. A leading judicial decision relating to the assignment of income doctrine involved a case in which a taxpayer made a gift of detachable interest coupons before their due date while retaining the bearer bond. The U.S. Supreme Court ruled that the donor was taxable on the entire amount of interest when paid to the donee on the grounds that the transferor had "assigned" to the donee the right to receive the income.[202]

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).[203] However, there are no specific statutory rules that address stripping transactions with respect to common stock or other equity interests (other than preferred stock).[204]

Stripped bonds

Special rules are provided with respect to the purchaser and "stripper" of stripped bonds.[205] 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.[206] In general, upon the disposition of either the stripped bond or the detached interest coupons each of the retained portion and the portion that is disposed 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.[207] 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 at-

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

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

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

[205] Sec. 1286.

[206] Sec. 1286(e).

[207] Sec. 1286(a).

tached) between the retained and disposed items.[208] Special rules apply to require that interest or market discount accrued on the bond prior to such disposition must be included in the taxpayer's gross income (to the extent that it had not been previously included in income) at the time the stripping occurs, and the taxpayer increases his basis in the bond by the amount of such accrued interest or market discount. The adjusted basis (as increased by any accrued interest or market discount) is then allocated between the stripped bond and the stripped interest coupons in relation to their respective fair market values. Amounts realized from the sale of stripped coupons or bonds constitute income to the taxpayer only to the extent such amounts exceed the basis allocated to the stripped coupons or bond. With respect to retained items (either the detached coupons or stripped bond), to the extent that the price payable on maturity, or on the due date of the coupons, exceeds the portion of the taxpayer's basis allocable to such retained items, the difference is treated as OID that is required to be included under the general OID periodic income inclusion rules.[209]

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.[210] 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.[211] 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.[212]

REASONS FOR CHANGE

The Committee is concerned that taxpayers are entering into tax avoidance transactions to generate artificial losses, or defer the recognition of ordinary income and convert such income into capital gains, by selling or purchasing stripped interests that are not subject to the present-law rules relating to stripped bonds and preferred stock but that represent interests in bonds or preferred stock. Therefore, the Committee believes that it is appropriate to provide Treasury with regulatory authority to apply such rules to interests that do not constitute bonds or preferred stock but nevertheless derive their economic value and characteristics exclusively from underlying bonds or preferred stock.

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[208] 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.

[209] 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)).

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

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

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

EXPLANATION OF PROVISION

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

For example, such Treasury regulations could apply to a transaction in which a person effectively strips future dividends from shares in a money market mutual fund (and disposes either the stripped shares or stripped future dividends) by contributing the shares (with the future dividends) to a custodial account through which another person purchases rights to either the stripped shares or the stripped future dividends. However, it is intended that Treasury regulations issued under this provision would not apply to certain transactions involving direct or indirect interests in an entity or account substantially all the assets of which consist of tax-exempt obligations (as defined in section 1275(a)(3)), such as a tax-exempt bond partnership described in Rev. Proc. 2002–68,[213] modifying and superceding Rev. Proc. 2002–16.[214]

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

EFFECTIVE DATE

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

2. Minimum holding period for foreign tax credit on withholding taxes on income other than dividends (sec. 3022 of the bill and sec. 901 of the Code)

PRESENT LAW

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

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

[213] 2002–43 I.R.B. 753.
[214] 2002–9 I.R.B. 572.

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

REASONS FOR CHANGE

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

EXPLANATION OF PROVISION

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

EFFECTIVE DATE

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

3. Disallowance of certain partnership loss transfers (sec. 3023 of the bill and secs. 704, 734, and 743 of the Code)

PRESENT LAW

Contributions of property

Under present law, if a partner contributes property to a partnership, generally no gain or loss is recognized to the contributing partner at the time of contribution.[215] The partnership takes the property at an adjusted basis equal to the contributing partner's adjusted basis in the property.[216] The contributing partner increases its basis in its partnership interest by the adjusted basis of the contributed property.[217] Any items of partnership income, gain, loss and deduction with respect to the contributed property are allocated among the partners to take into account any built-in gain or loss at the time of the contribution.[218] 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.[219]

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.[220] 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.[221] If an election is in effect, adjustments are made with respect to the transferee partner in order to account for the difference between the transferee partner's proportionate share of the adjusted basis of the partnership property and the transferee's basis in its partnership interest.[222] 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).

[215] Sec. 721.
[216] Sec. 723.
[217] Sec. 722.
[218] 704(c)(1)(A).
[219] If 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. 1.704–3(c) and (d).
[220] Treas. Reg. 1.704–3(a)(7).
[221] Sec. 743(a).
[222] Sec. 743(b).

Distributions of partnership property

With certain exceptions, partners may receive distributions of partnership property without recognition of gain or loss by either the partner or the partnership.[223] 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).[224] 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).[225]

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.[226] 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 distributee partner).[227] 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.

REASONS FOR CHANGE

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

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

EXPLANATION OF PROVISION

Contributions of property

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

[223] Sec. 731(a) and (b).
[224] Sec. 732(b).
[225] Sec. 732(a).
[226] Sec. 734(a).
[227] Sec. 734(b).

the time 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 time of contribution, and the built-in loss is eliminated.[228]

Transfers of partnership interests

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

Thus, for example, assume that partner A sells his 25-percent partnership interest to B for its fair market value of $1 million. Also assume that, immediately after the transfer, the fair market value of partnership assets is $4 million and the partnership's adjusted basis in the partnership assets is $4.3 million. Under the bill, section 743(b) applies, so that a $300,000 decrease is required to the adjusted basis of the partnership assets with respect to B. As a result, B would recognize no gain or loss if the partnership immediately sold all its assets for their fair market value.

Distributions of partnership property

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

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

Under the provision, however, there is a substantial basis adjustment because the $2 million increase in the adjusted basis of LMN stock (described in section 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 of 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.

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[228] 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.

4. No reduction of basis under section 734 in stock held by partnership in corporate partner (sec. 3024 of the bill and sec. 755 of the Code)

PRESENT LAW

In general

Generally, a partner and the partnership do not recognize gain or loss on a contribution of property to a partnership.[229] Similarly, a partner and the partnership generally do not recognize gain or loss on the distribution of partnership property.[230] This includes current distributions and distributions in liquidation of a partner's interest.

Basis of property distributed in liquidation

The basis of property distributed in liquidation of a partner's interest is equal to the partner's tax basis in its partnership interest (reduced by any money distributed in the same transaction).[231] 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.[232] 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 that has the effect of reducing the

[229] Sec. 721(a).
[230] Sec. 731(a) and (b).
[231] Sec. 732(b).
[232] Sec. 754.

difference between the fair market value and the adjusted basis of partnership properties.[233] 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.[234]

REASONS FOR CHANGE

The Joint Committee on Taxation staff's investigative report of Enron Corporation[235] revealed that certain transactions were being undertaken that purported to use the interaction of the partnership basis adjustment rules and the rules protecting a corporation from recognizing gain on its stock to obtain unintended tax results. These transactions generally purported to increase the tax basis of depreciable assets and to decrease, by a corresponding amount, the tax basis of the stock of a partner. Because the tax rules protect a corporation from gain on the sale of its stock (including through a partnership), the transactions enable taxpayers to duplicate tax deductions at no economic cost. The provision precludes the ability to reduce the basis of corporate stock of a partner (or related party) in certain transactions.

EXPLANATION OF PROVISION

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

5. Repeal of special rules for FASITs, etc. (sec. 3025 of the bill and secs. 860H through 860L of the Code)

PRESENT LAW

Financial asset securitization investment trusts

In 1996, Congress created a new type of statutory entity called a "financial asset securitization trust" ("FASIT") that facilitates the securitization of debt obligations such as credit card receivables, home equity loans, and auto loans.[236] A FASIT generally is not taxable. Instead, 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 held entirely by a single domestic C corporation. In addition, a FASIT generally may hold only qualified

[233] Sec. 755(a).
[234] Sec. 755(b).
[235] See Joint Committee on Taxation, Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations (JCS–3–03), February 2003.
[236] Sections 860H through 860L.

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.

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

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

Permitted assets

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

"Regular interests" of a FASIT

"Regular interests" of a FASIT are treated as debt for Federal income tax purposes, regardless of whether instruments with similar terms issued by non-FASITs might be characterized as equity under general tax principles. To be treated as a "regular interest", an instrument generally 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 Secretary, variable rates permitted with respect to real estate mortgage investment conduit 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

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

percentage points above the applicable Federal rate ("AFR") for the calendar month in which the instrument is issued. Instruments that do not satisfy certain of these general requirements nevertheless may be treated as regular interests if they are held by a domestic taxable C corporation that is not a RIC, real estate investment trust ("REIT"), FASIT, or cooperative.

Transfers to FASITs

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

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

Real estate mortgage investment conduits

In general, a real estate mortgage investment conduit ("REMIC") is a self-liquidating entity that holds a fixed pool of mortgages and issues multiple classes of investor interests. A REMIC is not treated as a separate taxable entity. Rather, the income of the REMIC is allocated to, and taken into account by, the holders of the interests in the REMIC under detailed rules.[238] In order to qualify as a REMIC, substantially all of the assets of the entity must consist of qualified mortgages and permitted investments as of the close of the third month beginning after the startup day of the entity. A "qualified mortgage" generally includes any obligation which is principally secured by an interest in real property, and which is either transferred to the REMIC on the startup day of the REMIC in exchange for regular or residual interests in the REMIC or purchased by the REMIC within three months after the startup day pursuant to a fixed-price contract in effect on the startup day. A "permitted investment" generally includes any intangible property that is held for investment and is part of a reasonably required reserve to provide for full payment of certain expenses of the REMIC or amounts due on regular interests.

All of the interests in the REMIC must consist of one or more classes of regular interests and a single class of residual interests. A "regular interest" is an interest in a REMIC that is issued with a fixed term, designated as a regular interest, and unconditionally entitles the holder to receive a specified principal amount (or other similar amount) with interest payments that are either based on a fixed rate (or, to the extent provided in regulations, a variable rate) or consist of a specified portion of the interest payments on qualified mortgages that does not vary during the period such interest is outstanding. In general, a "residual interest" is any interest in the REMIC other than a regular interest, and which is so designated by the REMIC, provided that there is only one class of such interest and that all distributions (if any) with respect to such

[238] See sections 860A through 860G.

interests are pro rata. Holders of residual REMIC interests are subject to tax on the portion of the income of the REMIC that is not allocated to the regular interest holders.

Original issue discount accruals with respect to debt instruments and pools of debt instruments subject to acceleration of principal payment

The holder of a debt instrument with original issue discount ("OID") generally accrues and includes in gross income, as interest, the OID over the life of the obligation, even though the amount of the interest may not be received until the maturity of the instrument.[239] In general, issuers of debt instruments with OID accrue and deduct the amount of OID as interest expense in the same manner as the holder.

Special rules for determining the amount of OID allocated to a period apply to certain instruments and pools of instruments that may be subject to prepayment. First, if a borrower can reduce the yield on a debt by exercising a prepayment option, the OID rules assume that the borrower will prepay the debt. In addition, in the case of (1) any regular interest in a REMIC or qualified mortgage held by a REMIC, (2) any other debt instrument if payments under the instrument may be accelerated by reason of prepayments of other obligations securing the instrument, or (3) any pool of debt instruments the yield on which may be affected by reason of prepayments, the daily portions of the OID on such debt instruments and pools of debt instruments generally are determined by taking into account an assumption regarding the prepayment of principal for such instruments. The prepayment assumption to be used for this purpose is that which the parties use in pricing the particular transaction.

REASONS FOR CHANGE

The Joint Committee on Taxation staff's investigative report of Enron Corporation[240] described two structured tax-motivated transactions—Projects Apache and Renegade—that Enron undertook in which the use of a FASIT was a key component in the structure of the transactions. The Committee is aware that FASITs are not being used widely in the manner envisioned by the Congress and, consequently, the FASIT rules have not served the purpose for which they originally were intended. Moreover, the Joint Committee's report indicates that FASITs are particularly prone to abuse and likely are being used primarily to facilitate tax avoidance transactions. Therefore, the Committee believes that the potential for abuse that is inherent in FASITs far outweighs any beneficial purpose that the FASIT rules may serve. Accordingly, the Committee believes that these rules should be repealed, with ap-

[239] The amount of OID with respect to a debt instrument is the excess of the stated redemption price at maturity over the issue price of the debt instrument. The stated redemption price at maturity includes all amounts payable at maturity. The amount of OID in a debt instrument is allocated over the life of the instrument through a series of adjustments to the issue price for each accrual period. The adjustment to the issue price is determined by multiplying the adjusted issue price (i.e., the issue price increased by adjustments prior to the accrual period) by the instrument's yield to maturity, and then subtracting the interest payable during the accrual period.

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

propriate transition relief for existing FASITs and appropriate modifications to the present-law REMIC rules to permit the use of REMICs by taxpayers that have relied upon FASITs to securitize certain obligations secured by an interest in real property.

EXPLANATION OF PROVISION

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

For purposes of the REMIC rules, the provision also modifies the definitions of REMIC regular interests, qualified mortgages, and permitted investments so that certain types of real estate loans and loan pools can be transferred to, or purchased by, a REMIC. Specifically, the provision modifies the present-law definition of a REMIC "regular interest" to provide that an interest in a REMIC does not fail to qualify as a regular interest solely because the specified principal amount of such interest or the amount of interest accrued on such interest could be reduced as a result of the nonoccurrence of one or more contingent payments with respect to one or more reverse mortgages loans, as defined below, that are held by the REMIC, provided that on the startup day for the REMIC, the REMIC sponsor reasonably believes that all principal and interest due under the interest will be paid at or prior to the liquidation of the REMIC. For this purpose, a reasonable belief concerning ultimate payment of all amounts due under an interest is presumed to exist if, as of the startup day, the interest receives an investment grade rating from at least one nationally recognized statistical rating agency.

In addition, the provision makes three modifications to the present-law definition of a "qualified mortgage." First, the provision modifies the definition to include an obligation principally secured by real property which represents an increase in the principal amount under the original terms of an obligation, provided such increase: (1) is attributable to an advance made to the obligor pursuant to the original terms of the obligation; (2) occurs after the REMIC startup day; and (3) is purchased by the REMIC pursuant to a fixed price contract in effect on the startup day. Second, the provision modifies the definition to generally include reverse mortgage loans and the periodic advances made to obligors on such loans. For this purpose, a "reverse mortgage loan" is defined as a loan that: (1) is secured by an interest in real property; (2) provides for one or more advances of principal to the obligor (each such advance giving rise to a "balance increase"), provided such advances are principally secured by an interest in the same real property as that which secures the loan; (3) may provide for a contingent payment at maturity based upon the value or appreciation in value of the real property securing the loan; (4) provides for an amount due at maturity that cannot exceed the value, or a specified fraction of the value, of the real property securing the loan; (5) provides that all payments under the loan are due only upon the maturity of the loan; and (6) matures after a fixed term or at the time the obligor ceases to use as a personal residence the real property securing the loan. Third, the provision modifies the definition to provide that, if more than 50 percent of the obligations transferred to, or purchased by, the REMIC are (1) originated by the United States or any State (or any political subdivision, agency, or instrumentality of the United States or any State) and (2) principally secured by an interest in real property, then each obligation transferred to, or purchased by, the REMIC shall be treated as secured by an interest in real property.

In addition, the provision modifies the present-law definition of a "permitted investment" to include intangible investment property held as part of a reasonably required reserve to provide a source of funds for the purchase of obligations described above as part of the modified definition of a "qualified mortgage."

The provision also modifies the OID rules with respect to certain instruments and pools of instruments that may be subject to principal prepayment by directing the Secretary to prescribe regulations permitting the use of a current prepayment assumption determined as of the close of the accrual period (or such other time as the Secretary may prescribe during the taxable year in which the accrual period ends).

EFFECTIVE DATE

Except as provided by the transition period for existing FASITs, the provision is effective for taxable years beginning after December 31, 2003.

6. Limitation on transfer of built-in losses on REMIC residuals (sec. 3026 of the bill and sec. 362 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.[241] 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.[242]

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.[243]

REASONS FOR CHANGE

The Joint Committee on Taxation staff's investigative report of Enron Corporation[244] revealed that Enron was using REMIC residual interests in tax motivated transactions to purportedly duplicate

[241] Sec. 351.
[242] Sec. 358.
[243] Secs. 334(b) and 362(a) and (b).
[244] See Joint Committee on Taxation, Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations (JCS–3–03), February 2003.

a single economic loss and deduct the loss more than once. The Committee understands that, under the statutory rules regarding the taxation of REMICS, phantom income is allocated to REMIC residual interest holders. Because of the associated basis increases in the REMIC residual interests, the phantom income allocation inevitably creates built-in losses to the holders of the REMIC residual interests, thus making such interests a natural component of transactions designed to duplicate a single economic loss. Congress did not intend REMIC residual interests to be used in this manner. Therefore, the Committee believes that a corporation's basis in REMIC residual interests acquired in a tax-free transfer should be limited to the fair market value of such interests.

EXPLANATION OF PROVISION

The provision provides that if a residual interest (as defined in section 860G(a)(2)) in a real estate mortgage investment conduit ("REMIC") is contributed to a corporation and the transferee corporation's adjusted basis in the REMIC residual interest would (but for the provision) exceed the fair market value of the REMIC residual interest immediately after the contribution, the transferee corporation's adjusted basis in the REMIC residual interest is limited to the fair market value of the REMIC residual interest immediately after the contribution, regardless of whether the fair market value of the REMIC residual interest is less than, equal to, or greater than zero (i.e., the provision may result in the transferee corporation having a negative adjusted basis in the REMIC residual interest).

EFFECTIVE DATE

The provision applies to transactions after the date of enactment.

7. Clarification of banking business for purposes of determining investment of earnings in U.S. property (sec. 3027 of the bill and sec. 956 of the Code)

PRESENT LAW

In general, the subpart F rules[245] require the U.S. 10-percent shareholders of a controlled foreign corporation to include in income currently their pro rata shares of certain income of the controlled foreign corporation (referred to as "subpart F income"), whether or not such earnings are distributed currently to the shareholders. In addition, the U.S. 10-percent shareholders of a controlled foreign corporation are subject to U.S. tax currently on their pro rata shares of the controlled foreign corporation's earnings to the extent invested by the controlled foreign corporation in certain U.S. property.[246]

A shareholder's current income inclusion with respect to a controlled foreign corporation's investment in U.S. property for a taxable year is based on the controlled foreign corporation's average investment in U.S. property for such year. For this purpose, the U.S. property held (directly or indirectly) by the controlled foreign corporation must be measured as of the close of each quarter in the

[245] Secs. 951–964.
[246] Sec. 951(a)(1)(B).

taxable year.[247] The amount taken into account with respect to any property is the property's adjusted basis as determined for purposes of reporting the controlled foreign corporation's earnings and profits, reduced by any liability to which the property is subject. The amount determined for current inclusion is the shareholder's pro rata share of an amount equal to the lesser of: (1) the controlled foreign corporation's average investment in U.S. property as of the end of each quarter of such taxable year, to the extent that such investment exceeds the foreign corporation's earnings and profits that were previously taxed on that basis; or (2) the controlled foreign corporation's current or accumulated earnings and profits (but not including a deficit), reduced by distributions during the year and by earnings that have been taxed previously as earnings invested in U.S. property.[248] An income inclusion is required only to the extent that the amount so calculated exceeds the amount of the controlled foreign corporation's earnings that have been previously taxed as subpart F income.[249]

For purposes of section 956, U.S. property generally is defined to include tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person, and certain intangible assets including a patent or copyright, an invention, model or design, a secret formula or process or similar property right which is acquired or developed by the controlled foreign corporation for use in the United States.[250]

Specified exceptions from the definition of U.S. property are provided for: (1) obligations of the United States, money, or deposits with persons carrying on the banking business; (2) certain export property; (3) certain trade or business obligations; (4) aircraft, railroad rolling stock, vessels, motor vehicles or containers used in transportation in foreign commerce and used predominantly outside of the United States; (5) certain insurance company reserves and unearned premiums related to insurance of foreign risks; (6) stock or debt of certain unrelated U.S. corporations; (7) moveable property (other than a vessel or aircraft) used for the purpose of exploring, developing, or certain other activities in connection with the ocean waters of the U.S. Continental Shelf; (8) an amount of assets equal to the controlled foreign corporation's accumulated earnings and profits attributable to income effectively connected with a U.S. trade or business; (9) property (to the extent provided in regulations) held by a foreign sales corporation and related to its export activities; (10) certain deposits or receipts of collateral or margin by a securities or commodities dealer, if such deposit is made or received on commercial terms in the ordinary course of the dealer's business as a securities or commodities dealer; and (11) certain repurchase and reverse repurchase agreement transactions entered into by or with a dealer in securities or commodities in the ordinary course of its business as a securities or commodities dealer.[251]

With regard to the exception for deposits with persons carrying on the banking business, the U.S. Court of Appeals for the Sixth

[247] Sec. 956(a).
[248] Secs. 956 and 959.
[249] Secs. 951(a)(1)(B) and 959.
[250] Sec. 956(c)(1).
[251] Sec. 956(c)(2).

Circuit in *The Limited, Inc.* v. *Commissioner*[252] concluded that a U.S. subsidiary of a U.S. shareholder was "carrying on the banking business" even though its operations were limited to the administration of the private label credit card program of the U.S. shareholder. Therefore, the court held that a controlled foreign corporation of the U.S. shareholder could make deposits with the subsidiary (e.g., through the purchase of certificates of deposit) under this exception, and avoid taxation of the deposits under section 956 as an investment in U.S. property.

REASONS FOR CHANGE

The Committee believes that further guidance is necessary under the U.S. property investment provisions of subpart F with regard to the treatment of deposits with persons carrying on the banking business. In particular, the Committee believes that the transaction at issue in *The Limited* case was not contemplated or intended by Congress when it excepted from the definition of U.S. property deposits with persons carrying on the banking business. Therefore, the Committee believes that it is appropriate and necessary to clarify the scope of this exception so that it applies only to deposits with regulated banking businesses and their affiliates.

EXPLANATION OF PROVISION

The provision provides that the exception from the definition of U.S. property under section 956 for deposits with persons carrying on the banking business is limited to deposits with corporations with respect to which a bank holding company (as defined by section 2(a) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(c)) or financial holding company (as defined by section 2(p) of such Act) owns directly or indirectly more than 80 percent by vote or value of the stock of such corporation.

No inference is intended as to the meaning of the phrase "carrying on the banking business" under present law or whether this phrase was correctly interpreted by the Sixth Circuit in *The Limited.*

EFFECTIVE DATE

This provision is effective on the date of enactment.

8. Modify rules related to certain small property and casualty insurance companies (sec. 3028 of the bill and secs. 501(c)(15) and 831(b) of the Code)

PRESENT LAW

A property and casualty insurance company generally is subject to tax on its taxable income (sec. 831(a)). 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).

A property and casualty insurance company is eligible to be exempt from Federal income tax if its net written premiums or direct

[252] 286 F.3d 324 (6th Cir. 2002), rev'g 113 T.C. 169 (1999).

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).

REASONS FOR CHANGE

The Committee has become aware of abuses in the area of tax-exempt insurance companies.[253] The Committee believes that the use of these organizations as vehicles for sheltering income was never contemplated by Congress. The Committee believes it is necessary to limit the availability of tax-exempt status under the provision so that it cannot be abused. To that end, the bill applies a gross receipts test and requires that premiums received for the taxable year be greater than 50 percent of gross receipts.

The bill correspondingly expands the availability of the present-law election of a property and casualty insurer to be taxed only on taxable investment income to companies with premiums below $350,000, and also increases the upper limit on premiums to $1.89 million (indexed for inflation) for purposes of the election. This provision of present law provides a relatively simple tax calculation for small property and casualty insurers, and because the election results in the taxation of taxable investment income, the Committee does not believe that it is abused to avoid tax on investment income. Thus, the bill provides that a company whose net written premiums (or if greater, direct written premiums) do not exceed the indexed $1.89 million amount (without regard to the $350,000 threshhold of present law), is eligible for the simplification benefit of this election.

EXPLANATION OF PROVISION

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

Under the provision, a property and casualty insurance company is eligible to be exempt from Federal income tax if (a) its gross receipts for the taxable year do not exceed $600,000, and (b) the premiums received for the taxable year are greater than 50 percent of its gross receipts. For purposes of determining gross receipts, the

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

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.

A company that does not meet the definition of an insurance company is not eligible to be exempt from Federal income tax under the bill. For this purpose, the term "insurance company" means any company, more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies (sec. 816(a) and new sec. 831(c)). A company whose investment activities outweigh its insurance activities is not considered to be an insurance company for this purpose.[254] It is intended that IRS enforcement activities address the misuse of present-law section 501(c)(15).

The provision also provides that a property and casualty insurance company may elect to be taxed only on taxable investment income if its net written premiums or direct written premiums (whichever is greater) do not exceed a specified amount (without regard to whether such premiums exceed $350,000) (sec. 831(b)). The provision increases from $1.2 million to $1.89 million the upper limit on net (or direct) written premiums for purposes of such election. The $1.89 million amount is indexed for inflation for taxable years beginning in calendar years after 2004. As under present law, 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 (as defined in section 831(b)) of which the company is a part are taken into account.

It is intended that regulations or other Treasury guidance provide for anti-abuse rules so as to prevent improper use of the provision, including, for example, by attempts to characterize as premiums any income that is other than premium income.

EFFECTIVE DATE

The provisions are effective for taxable years beginning after December 31, 2003.

9. Definition of insurance company for property and casualty insurance company tax rules (sec. 3029 of the bill and sec. 831(c) of the Code)

PRESENT LAW

Present law provides specific rules for taxation of the life insurance company taxable income of a life insurance company (sec. 801), and for taxation of the taxable income of a company other than a life insurance company (sec. 831) (generally referred to as a property and casualty insurance company). For Federal income tax purposes, a life insurance company means an insurance company that is engaged in the business of issuing life insurance and annuity contracts, or noncancellable health and accident insurance

[254] See, e.g., *Inter-American Life Insurance Co.* v. *Comm'r,* 56 T.C. 497, aff'd per curiam, 469 F.2d 697 (9th Cir. 1972).

contracts, and that meets a 50-percent test with respect to its reserves (sec. 816(a)). This statutory provision applicable to life insurance companies explicitly defines the term "insurance company" to mean any company, more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies (sec. 816(a)).

The life insurance company statutory definition of an insurance company does not explicitly apply to property and casualty insurance companies, although a long-standing Treasury regulation[255] that is applied to property and casualty companies provides a somewhat similar definition of an "insurance company" based on the company's "primary and predominant business activity."[256]

When enacting the statutory definition of an insurance company in 1984, Congress stated, "[b]y requiring [that] more than half rather than the 'primary and predominant business activity' be insurance activity, the bill adopts a stricter and more precise standard for a company to be taxed as a life insurance company than does the general regulatory definition of an insurance company applicable for both life and nonlife insurance companies * * * Whether more than half of the business activity is related to the issuing of insurance or annuity contracts will depend on the facts and circumstances and factors to be considered will include the relative distribution of the number of employees assigned to, the amount of space allocated to, and the net income derived from, the various business activities."[257]

REASONS FOR CHANGE

The Committee believes that this change will clarify the tax rules and improve the administration of those rules by conforming the definition of an insurance company for purposes of the property

[255] The Treasury regulation provides that "the term 'insurance company' means 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. Thus, though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code." Treas. Reg. section 1.801–3(a)(1).

[256] Court cases involving a determination of whether a company is an insurance company for Federal tax purposes have examined all of the business and other activities of the company. In considering whether a company is an insurance company for such purposes, courts have considered, among other factors, the amount and source of income received by the company from its different activities. See *Bowers* v. *Lawyers Mortgage Co.,* 285 U.S. 182 (1932); *United States* v. *Home Title Insurance Co.,* 285 U.S. 191 (1932). See also *Inter-American Life Insurance Co.* v. *Comm'r,* 56 T.C. 497, aff'd per curiam, 469 F.2d 697 (9th Cir. 1972), in which the court concluded that the company was not an insurance company: "The * * * financial data clearly indicates that petitioner's primary and predominant source of income was from its investments and not from issuing insurance contracts or reinsuring risks underwritten by insurance companies. During each of the years in issue, petitioner's investment income far exceeded its premiums and the amounts of earned premiums were de minimis during those years. It is equally as clear that petitioner's primary and predominant efforts were not expended in issuing insurance contracts or in reinsurance. Of the relatively few policies directly written by petitioner, nearly all were issued to [family members]. Also, Investment Life, in which [family members] each owned a substantial stock interest, was the source of nearly all of the policies reinsured by petitioner. These facts, coupled with the fact that petitioner did not maintain an active sales staff soliciting or selling insurance policies * * *, indicate a lack of concentrated effort on petitioner's behalf toward its chartered purpose of engaging in the insurance business. * * * For the above reasons, we hold that during the years in issue, petitioner was not 'an insurance company * * * engaged in the business of issuing life insurance' and hence, that petitioner was not a life insurance company within the meaning of section 801." 56 T.C. 497, 507–508.

[257] H.R. Rep. 98–432, part 2, at 1402–1403 (1984); S. Prt. No. 98–169, vol. I, at 525–526 (1984); see also H.R. Rep. No. 98–861 at 1043–1044 (1985) (Conference Report).

and casualty insurance rules and the life insurance rules. Further, the Committee expects that IRS enforcement activities to prevent abuse of the provision relating to tax-exempt insurance companies will be simplified and improved by this provision of the bill.

EXPLANATION OF PROVISION

The bill provides that, for purposes of determining whether a company is a property and casualty insurance company, the term "insurance company" is defined to mean any company, more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Thus, the bill conforms the definition of an insurance company for purposes of the rules taxing property and casualty insurance companies to the rules taxing life insurance companies, so that the definition is uniform. The provision adopts a stricter and more precise standard than the "primary and predominant business activity" test contained in Treasury Regulations. A company whose investment activities outweigh its insurance activities is not considered to be an insurance company under the provision.[258] It is not intended that a company whose sole activity is the run-off of risks under the company's insurance contracts be treated as a company other than an insurance company, even if the company has little or no premium income.

EFFECTIVE DATE

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

10. Denial of deduction for interest on underpayments attributable to nondisclosed reportable transactions (sec. 3030 of the bill and sec. 163 of the Code)

PRESENT LAW

In general, corporations may deduct interest paid or accrued within a taxable year on indebtedness.[259] Interest on indebtedness to the Federal government attributable to an underpayment of tax generally may be deducted pursuant to this provision.

REASONS FOR CHANGE

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

EXPLANATION OF PROVISION

The provision disallows any deduction for interest paid or accrued within a taxable year on any portion of an underpayment of tax that is attributable to an understatement arising from an undisclosed listed transaction or from an undisclosed reportable transaction (other than a listed transaction) if a significant purpose

[258] See *Inter-American Life Insurance Co. v. Comm'r, supra.*
[259] Sec. 163(a).

of such transaction is the avoidance or evasion of Federal income tax.[260]

EFFECTIVE DATE

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

11. Clarification of rules for payment of estimated tax for certain deemed asset sales (sec. 3031 of the bill and sec. 338 of the Code)

PRESENT LAW

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

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

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

REASONS FOR CHANGE

The Committee is concerned that some taxpayers may inappropriately be taking the position that estimated tax and the penalty (computed in the amount of an interest charge) under section 6655 applies neither to the stock sale nor to the asset sale in the case of a section 338(h)(10) election. The Committee believes that estimated tax should not be avoided merely because an election may be made under section 338(h)(10). Furthermore, the Committee understands that parties typically negotiate a sale with an understanding as to whether or not an election under section 338(h)(10) will be made. In the event there is a contingency in this regard, the parties would typically provide for adjustments to the price to reflect the effect of the election.

[260] The definitions of these transactions are the same as those previously described in connection with the provision elsewhere in this bill to modify the accuracy-related penalty for listed and certain reportable transactions.

EXPLANATION OF PROVISION

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

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

If at the time of the sale there is an agreement of the parties to make a section 338(h)(10) election, then estimated tax is computed based on an asset sale, computed from the date of the sale.

If the agreement to make a section 338(h)(10) election is concluded after the stock sale, such that the original computation was based on a stock sale, estimated tax is recomputed based on the asset sale election.

No inference is intended as to present law.

EFFECTIVE DATE

The bill is effective for qualified stock purchase transactions that occur after the date of enactment.

12. Exclusion of like-kind exchange property from nonrecognition treatment on the sale or exchange of a principal residence (sec. 3032 of the bill 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.[261] 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.

REASONS FOR CHANGE

The Committee believes that the present-law exclusion of gain allowable upon the sale or exchange of principal residences serves an important role in encouraging home ownership. The Committee does not believe that this exclusion is appropriate for properties that were recently acquired in like-kind exchanges. Under the like-kind exchange rules, a taxpayer that exchanges property that was held for productive use or investment for like-kind property may acquire the replacement property on a tax-free basis. Because the replacement property generally has a low carry-over tax basis, the

[261] Sec. 121.

taxpayer will have taxable gain upon the sale or exchange of the replacement property. However, when the taxpayer converts the replacement property into the taxpayer's principal residence, the taxpayer may shelter some or all of this gain from income taxation. The Committee believes that this proposal balances the concerns associated with these provisions to reduce this tax shelter concern without unduly limiting the exclusion on sales or exchanges of principal residences.

EXPLANATION OF PROVISION

The bill 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 provision is effective for sales or exchanges of principal residences after the date of enactment.

13. Prevention of mismatching of interest and original issue discount deductions and income inclusions in transactions with related foreign persons (sec. 3033 of the bill and secs. 163 and 267 of the Code)

PRESENT LAW

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

As a general rule, there is allowed as a deduction all interest paid or accrued within the taxable year with respect to indebtedness, including the aggregate daily portions of original issue discount ("OID") of the issuer for the days during such taxable year.[262] 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

[262] Section 163(e)(1).

rate of taxation under a treaty obligation).[263] 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.[264]

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.[265] 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).[266] As in the case of OID, the Treasury regulations additionally provide that in the case of stated 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.[267]

REASONS FOR CHANGE

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

[263] Section 163(e)(3).
[264] Treas. Reg. sec. 1.163–12(b)(3). In the case of a PFIC, the regulations further require that the person owing the amount at issue has in effect a qualified electing fund election pursuant to section 1295 with respect to the PFIC.
[265] Section 267(a)(2).
[266] Treas. Reg. sec. 1.267(a)–3(b)(1), (c).
[267] Treas. Reg. sec. 1.267(a)–3(c)(4).

could reduce a CFC's income that would be currently taxable to its U.S. shareholders under subpart F.

EXPLANATION OF PROVISION

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

EFFECTIVE DATE

The provision is effective for payments accrued on or after date of enactment.

14. Exclusion from gross income for interest on overpayments of income tax by individuals (sec. 3034 of the bill and new sec. 139A of the Code)

PRESENT LAW

Overpayment interest

Interest is included in the list of items that are required to be included in gross income (sec. 61(a)(4)). Interest on overpayments of Federal income tax is required to be included in taxable income in the same manner as any other interest that is received by the taxpayer.

Cash basis taxpayers are required to report overpayment interest as income in the period the interest is received. Accrual basis taxpayers are required to report overpayment interest as income when all events fixing the right to the receipt of the overpayment interest have occurred and the amount can be estimated with reasonable accuracy. Generally, this occurs on the date the appropriate IRS official signs the pertinent schedule of overassessments.

Underpayment interest

A corporate taxpayer is allowed to currently take into account interest paid on underpayments of Federal income tax as an ordinary and necessary business expense. Typically, this results in a current deduction. However, the deduction may be deferred if the interest is required to be capitalized or may be disallowed if and to the extent it is determined to be a cost of earning tax exempt income under section 265.

Section 163(h) of the Code prohibits the deduction of personal interest by taxpayers other than corporations. Noncorporate taxpayers, including individuals, generally are not allowed to deduct interest on the underpayment of Federal income taxes.

Temporary regulations provide that personal interest includes interest paid on underpayments of individual Federal, State or local income taxes, regardless of the source of the income generating the tax liability. This is consistent with the statement in the General Explanation of the Tax Reform Act of 1986 that "(p)ersonal interest also includes interest on underpayments of individual Federal, State, or local income taxes notwithstanding that all or a portion of the income may have arisen in a trade or business, because such taxes are not considered derived from conduct of a trade or business." The validity of the temporary regulation has been upheld in those Circuits that have considered the issue, including the Fourth, Sixth, Eighth, and Ninth Circuits.

Personal interest also includes interest that is paid by a trust, S corporation, or other pass-through entity on underpayments of State or local income taxes. Personal interest does not include interest that is paid with respect to sales, excise or similar taxes that are incurred in connection with a trade or business or an investment activity.

REASONS FOR CHANGE

The Committee believes that there should be consistency in the treatment of interest paid by the Federal government to an individual taxpayer and interest paid by an individual taxpayer to the Federal government. Allowing individual taxpayers to exclude interest on overpayments will treat all individual taxpayers consistently, whether or not they itemize deductions.

EXPLANATION OF PROVISION

The provision excludes overpayment interest that is paid to individual taxpayers on overpayments of Federal income tax from gross income. Interest excluded under the provision is not considered disqualified income that could limit the earned income credit. Interest excluded under the provision also is not considered in determining what portion of a taxpayer's Social Security or tier 1 railroad retirement benefits are subject to tax (sec. 86), whether a taxpayer has sufficient taxable income to be required to file a return (sec. 6012(d)), or for any other computation in which interest exempt from tax is otherwise required to be added to adjusted gross income.

The exclusion from income of overpayment interest does not apply if the Secretary determines that the taxpayer's principal purpose for overpaying his or her tax is to take advantage of the exclusion.

For example, a taxpayer prepares his return without taking into account significant itemized deductions of which he is, or should be, aware. Before the expiration of the statute of limitations, the taxpayer files an amended return claiming these itemized deductions and requesting a refund with interest. Unless the taxpayer can establish a principal purpose for originally overpaying the tax other than collecting excludible interest, the Secretary may determine that the principal purpose of waiting to claim the deductions on an amended return was to earn interest that would be excluded from income. In that case, the interest on the overpayment could not be excluded from income.

It is expected that the Secretary will indicate whether the interest is eligible to be excluded from income on the Form 1099 it provides that taxpayer for taxable year in which the underpayment interest is paid.

EFFECTIVE DATE

The provision is effective for interest received in calendar years beginning after the date of enactment.

15. Deposits made to suspend the running of interest on potential underpayments (sec. 3035 of the bill and new sec. 6603 of the Code)

PRESENT LAW

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

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

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

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

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

REASONS FOR CHANGE

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

EXPLANATION OF PROVISION

In general

The provision allows a taxpayer to deposit cash with the IRS that 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 deposited for the period that the amount is on deposit. Generally, deposited amounts that have not been used to pay a tax may be withdrawn at any time if the taxpayer so requests in writing. The withdrawn amounts will earn interest at the applicable Federal rate to the extent they are attributable to a disputable tax.

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

Use of a deposit to offset underpayments of tax

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

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

Withdrawal of amounts

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

For example, assume a calendar year individual taxpayer receives a 30-day letter showing a deficiency of $20,000 for taxable year 2004 and deposits $20,000 on May 15, 2006. On April 15, 2007, an administrative appeal is completed, and the taxpayer and the IRS agree that the 2004 taxes were underpaid by $15,000. $15,000 of the deposit is used to pay the underpayment. In this case, the taxpayer will owe underpayment interest from April 15, 2005 (the original due date of the return) to May 15, 2006, the date the $20,000 was deposited. Simultaneously with the use of the $15,000 to offset the underpayment, the taxpayer requests the return of the remaining amount of the deposit (after reduction for the underpayment interest owed by the taxpayer from April 15, 2005, to May 15, 2006). This amount must be returned to the taxpayer with interest determined at the short-term applicable Federal rate from the May 15, 2006, to a date not more than 30 days preceding the date of the check repaying the deposit to the taxpayer.

Limitation on amounts for which interest may be allowed

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

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

Deposits are not payments of tax

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

EFFECTIVE DATE

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

16. Authorize IRS to enter into installment agreements that provide for partial payment (sec. 3036 of the bill and sec. 6159 of the Code)

PRESENT LAW

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

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

REASONS FOR CHANGE

The Committee believes that clarifying that the IRS is authorized to enter into installment agreements with taxpayers which do not provide for full payment of the taxpayer's liability over the life of the agreement will improve effective tax administration.

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

EXPLANATION OF PROVISION

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

EFFECTIVE DATE

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

17. Extension of IRS user fees (sec. 3037 of the bill and sec. 7528 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.[268] Public Law 108–89[269] extended the statutory authorization for these user fees through December 31, 2004, and moved the statutory authorization for these fees into the Code.[270]

REASONS FOR CHANGE

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

EXPLANATION OF PROVISION

The provision extends the statutory authorization for these user fees through September 30, 2013.

EFFECTIVE DATE

The provision is effective for requests made after the date of enactment.

TITLE IV—TRADE ENHANCEMENT AND COMPLIANCE PROVISIONS

1. Repeal of exclusion for extraterritorial income (sec. 4001 of the bill and secs. 114 and 941–943 of the Code)

PRESENT LAW

The United States has long provided export-related benefits under a series of tax regimes, including the domestic international sales corporation ("DISC") regime, the foreign sales corporation ("FSC") regime, and the extraterritorial income ("ETI") regime. Each of these regimes has been found to violate U.S. obligations under international trade agreements. In 2000, the European Union ("EU") succeeded in having the FSC regime declared a prohibited export subsidy by the WTO. In response to this WTO ruling, the United States repealed the FSC rules and enacted a new regime under the FSC Repeal and Extraterritorial Income Exclu-

[268] These user fees were originally enacted in section 10511 of the Revenue Act of 1987 (Pub. Law No. 100–203, December 22, 1987). Public Law 104–117 (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)) extended the statutory authorization for these user fees through September 30, 2003.

[269] 117 Stat. 1131; H.R. 3146, signed by the President on October 1, 2003.

[270] That Public Law also moved 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).

sion Act of 2000. The EU immediately challenged the ETI regime in the WTO, and in January of 2002 a WTO Appellate Body held that the ETI regime also constituted a prohibited export subsidy under the relevant trade agreements.

Under the ETI regime, an exclusion from gross income applies with respect to "extraterritorial income," which is a taxpayer's gross income attributable to "foreign trading gross receipts." This income is eligible for the exclusion to the extent that it is "qualifying foreign trade income." Qualifying foreign trade income is the amount of gross income that, if excluded, would result in a reduction of taxable income by the greatest of: (1) 1.2 percent of the foreign trading gross receipts derived by the taxpayer from the transaction; (2) 15 percent of the "foreign trade income" derived by the taxpayer from the transaction;[271] or (3) 30 percent of the "foreign sale and leasing income" derived by the taxpayer from the transaction.[272]

Foreign trading gross receipts are gross receipts derived from certain activities in connection with "qualifying foreign trade property" with respect to which certain economic processes take place outside of the United States. Specifically, the gross receipts must be: (1) from the sale, exchange, or other disposition of qualifying foreign trade property; (2) from the lease or rental of qualifying foreign trade property for use by the lessee outside the United States; (3) for services which are related and subsidiary to the sale, exchange, disposition, lease, or rental of qualifying foreign trade property (as described above); (4) for engineering or architectural services for construction projects located outside the United States; or (5) for the performance of certain managerial services for unrelated persons. A taxpayer may elect to treat gross receipts from a transaction as not foreign trading gross receipts. As a result of such an election, a taxpayer may use any related foreign tax credits in lieu of the exclusion.

Qualifying foreign trade property generally is property manufactured, produced, grown, or extracted within or outside the United States that is held primarily for sale, lease, or rental in the ordinary course of a trade or business for direct use, consumption, or disposition outside the United States. No more than 50 percent of the fair market value of such property can be attributable to the sum of: (1) the fair market value of articles manufactured outside the United States; and (2) the direct costs of labor performed outside the United States. With respect to property that is manufactured outside the United States, certain rules are provided to ensure consistent U.S. tax treatment with respect to manufacturers.

REASONS FOR CHANGE

The Committee believes it is important that the United States, and all members of the WTO, comply with WTO decisions and honor their obligations under WTO agreements. Therefore, the Committee believes that the ETI regime should be repealed. The

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[271] "Foreign trade income" is the taxable income of the taxpayer (determined without regard to the exclusion of qualifying foreign trade income) attributable to foreign trading gross receipts.

[272] "Foreign sale and leasing income" is the amount of the taxpayer's foreign trade income (with respect to a transaction) that is properly allocable to activities that constitute foreign economic processes. Foreign sale and leasing income also includes foreign trade income derived by the taxpayer in connection with the lease or rental of qualifying foreign trade property for use by the lessee outside the United States.

Committee believes that it is necessary and appropriate to provide transition relief comparable to that which has been included in the past in measures taken by WTO members to bring their laws into compliance with WTO decisions and obligations.

The Committee also believes that it is important to use the opportunity afforded by the repeal of the ETI regime to reform the U.S. tax system in a manner that makes U.S. businesses and workers more productive and competitive than they are today. To this end, the Committee believes that it is important to provide tax cuts to U.S. domestic manufacturers and to update the U.S. international tax rules, which are over 40 years old and make U.S. companies uncompetitive in the United States and abroad.

EXPLANATION OF PROVISION

The bill repeals the ETI exclusion. Pursuant to transition rules, taxpayers retain a portion of their otherwise-applicable ETI benefits for transactions during a three-year transition period (80 percent for 2004 and 2005, and 60 percent for 2006). The bill also provides that the ETI exclusion provisions remain in effect for transactions in the ordinary course of a trade or business if such transactions are pursuant to a binding contract [273] between the taxpayer and an unrelated person and such contract is in effect on January 14, 2002, and at all times thereafter.

In addition, foreign corporations that elected to be treated for all Federal tax purposes as domestic corporations pursuant to an election available under the ETI rules are allowed to revoke such elections within one year of the date of enactment of the bill without recognition of gain or loss, subject to anti-abuse rules.

EFFECTIVE DATE

The provision is effective for transactions after December 31, 2003.

2. Extension of customs user fees (sec. 4002 of the bill)

PRESENT LAW

Section 13031 of the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) (P.L. 99–272), authorized the Secretary to collect certain service fees. Section 412 (P.L 107–296) of the Homeland Security Act of 2002 authorized the Secretary 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. 108–89, which extended authorization for the collection of these fees through March 31, 2004.

REASONS FOR CHANGE

The Committee believes it is important to extend these fees to cover the expenses of the services provided. However, the Com-

[273] This rule also applies to a purchase option, renewal option, or replacement option that is included in such contract.

mittee also believes it is important that any fee imposed be a true user fee. That is, the Committee believes that when the Congress authorizes the executive branch to assess user fees, those fees must be determined to reflect only the cost of providing the service for which the fee is assessed.

EXPLANATION OF PROVISION

The bill extends the certain merchandise processing fees authorized under the Consolidated Omnibus Budget Reconciliation Act of 1985 through September 30, 2013. Certain other fees, the so-called "COBRA fees" related to overtime and premium services, also are extended through September 30, 2013. For fiscal years after September 30, 2005, the Secretary is to charge fees in amount that are reasonably related to the costs of providing customs services in connection with the activity or item for which the fee is charged.

The bill also includes a Sense of the Congress that the fees set forth in paragraphs (1) through (8) of subsection (a) of section 13031 of the Consolidated Omnibus Budget Reconciliation Act of 1985 have been reasonably related to the costs of providing customs services in connection with the activities or items for which the fees have been charged under such paragraphs. The Sense of Congress also states that the fees collected under such paragraphs have not exceeded, in the aggregate, the amounts paid for the costs described in subsection (f)(3)(A) incurred in providing customs services in connection with the activities or items for which the fees were charged under such paragraphs.

The bill further provides that the Secretary conduct a study of all the fees collected by the Department of Homeland Security, and shall submit to the Congress, not later than September 30, 2005, a report containing the recommendations of the Secretary on what fees should be eliminated, what the rate of fees retains should be, and any other recommendations with respect to the fees that the Secretary considers appropriate.

EFFECTIVE DATE

The provisions are effective upon the date of enactment.

III. VOTES OF THE COMMITTEE

In compliance with clause 3(b) of rule XIII of the Rules of the House of Representatives, the following statements are made concerning the votes of the Committee on Ways and Means in its consideration of the bill, H.R. 2896.

MOTION TO REPORT THE BILL

The bill, H.R. 2896, as amended, was ordered favorably reported by a rollcall vote of 24 yeas to 15 nays (with a quorum being present). The vote was as follows:

Representatives	Yea	Nay	Present	Representatives	Yea	Nay	Present
Mr. Thomas	X			Mr. Rangel		X	
Mr. Crane	X			Mr. Stark		X	
Mr. Shaw	X			Mr. Matsui			
Mrs. Johnson	X			Mr. Levin		X	
Mr. Houghton	X			Mr. Cardin		X	
Mr. Herger	X			Mr. McDermott		X	

Representatives	Yea	Nay	Present	Representatives	Yea	Nay	Present
Mr. McCrery	X			Mr. Kleczka		X	
Mr. Camp	X			Mr. Lewis (GA)		X	
Mr. Ramstad	X			Mr. Neal		X	
Mr. Nussle	X			Mr. McNulty		X	
Mr. Johnson	X			Mr. Jefferson		X	
Ms. Dunn	X			Mr. Tanner			
Mr. Collins	X			Mr. Becerra		X	
Mr. Portman	X			Mr. Doggett		X	
Mr. English	X			Mr. Pomeroy		X	
Mr. Hayworth	X			Mr. Sandlin		X	
Mr. Weller	X			Ms. Tubbs Jones		X	
Mr. Hulshof	X						
Mr. McInnis	X						
Mr. Lewis (KY)	X						
Mr. Foley	X						
Mr. Brady	X						
Mr. Ryan	X						
Mr. Cantor	X						

VOTES ON AMENDMENTS

A rollcall vote was conducted on the following amendments to the Chairman's amendment in the nature of a substitute.

An amendment by Mr. Doggett, which would codify the economic substance doctrine and impose penalties for understatements attributable to transactions lacking economic substance, was defeated by a rollcall vote of 14 yeas to 24 nays. The vote was as follows:

Representatives	Yea	Nay	Present	Representatives	Yea	Nay	Present
Mr. Thomas		X		Mr. Rangel	X		
Mr. Crane		X		Mr. Stark	X		
Mr. Shaw		X		Mr. Matsui	X		
Mrs. Johnson		X		Mr. Levin	X		
Mr. Houghton		X		Mr. Cardin	X		
Mr. Herger		X		Mr. McDermott	X		
Mr. McCrery		X		Mr. Kleczka	X		
Mr. Camp		X		Mr. Lewis (GA)	X		
Mr. Ramstad		X		Mr. Neal	X		
Mr. Nussle		X		Mr. McNulty	X		
Mr. Johnson		X		Mr. Jefferson	X		
Ms. Dunn		X		Mr. Tanner	X		
Mr. Collins		X		Mr. Becerra	X		
Mr. Portman		X		Mr. Doggett	X		
Mr. English		X		Mr. Pomeroy	X		
Mr. Hayworth		X		Mr. Sandlin	X		
Mr. Weller		X		Ms. Tubbs Jones	X		
Mr. Hulshof		X					
Mr. McInnis		X					
Mr. Lewis (KY)		X					
Mr. Foley		X					
Mr. Brady		X					
Mr. Ryan		X					
Mr. Cantor		X					

An amendment by Mr. Doggett, which would override certain U.S. income tax treaties in certain circumstances, was defeated by a rollcall vote of 13 yeas to 24 nays. The vote was as follows:

Representatives	Yea	Nay	Present	Representatives	Yea	Nay	Present
Mr. Thomas	X			Mr. Rangel	X		
Mr. Crane		X		Mr. Stark	X		
Mr. Shaw		X		Mr. Matsui			
Mrs. Johnson		X		Mr. Levin	X		

Representatives	Yea	Nay	Present	Representatives	Yea	Nay	Present
Mr. Houghton		X		Mr. Cardin	X		
Mr. Herger	X			Mr. McDermott	X		
Mr. McCrery	X			Mr. Kleczka	X		
Mr. Camp	X			Mr. Lewis (GA)			
Mr. Ramstad	X			Mr. Neal	X		
Mr. Nussle	X			Mr. McNulty	X		
Mr. Johnson	X			Mr. Jefferson	X		
Ms. Dunn	X			Mr. Tanner			
Mr. Collins	X			Mr. Becerra	X		
Mr. Portman	X			Mr. Doggett	X		
Mr. English	X			Mr. Pomeroy			
Mr. Hayworth	X			Mr. Sandlin	X		
Mr. Weller	X			Ms. Tubbs Jones	X		
Mr. Hulshof	X						
Mr. McInnis	X						
Mr. Lewis (KY)	X						
Mr. Foley	X						
Mr. Brady	X						
Mr. Ryan	X						
Mr. Cantor	X						

A substitute amendment by Mr. Rangel was defeated by a rollcall vote of 13 yeas to 24 nays. The vote was as follows:

Representatives	Yea	Nay	Present	Representatives	Yea	Nay	Present
Mr. Thomas	X			Mr. Rangel	X		
Mr. Crane	X			Mr. Stark			
Mr. Shaw	X			Mr. Matsui			
Mrs. Johnson	X			Mr. Levin	X		
Mr. Houghton	X			Mr. Cardin	X		
Mr. Herger	X			Mr. McDermott	X		
Mr. McCrery	X			Mr. Kleczka	X		
Mr. Camp	X			Mr. Lewis (GA)	X		
Mr. Ramstad	X			Mr. Neal	X		
Mr. Nussle	X			Mr. McNulty	X		
Mr. Johnson	X			Mr. Jefferson	X		
Ms. Dunn	X			Mr. Tanner			
Mr. Collins	X			Mr. Becerra	X		
Mr. Portman	X			Mr. Doggett			
Mr. English	X			Mr. Pomeroy	X		
Mr. Hayworth	X			Mr. Sandlin	X		
Mr. Weller	X			Ms. Tubbs Jones	X		
Mr. Hulshof	X						
Mr. McInnis	X						
Mr. Lewis (KY)	X						
Mr. Foley	X						
Mr. Brady	X						
Mr. Ryan	X						
Mr. Cantor	X						

IV. BUDGET EFECTS OF THE BILL

A. Committee Estimate of Budgetary Effects

In compliance with clause 3(d)(2) of the rule XIII of the Rules of the House of Representatives, the following statement is made concerning the effects on the budget of the revenue provisions of the bill, H.R. 2896 as reported.

The bill is estimated to have the following effects on budget receipts for fiscal years 2003–2008:

ESTIMATED BUDGET EFFECTS OF H.R. 2896, THE "AMERICAN JOBS CREATION ACT OF 2003," AS REPORTED BY THE COMMITTEE ON WAYS AND MEANS

[Fiscal years 2004–2008, in millions of dollars]

Provision	Effective	2004	2005	2006	2007	2008	2004–08
Corporate Reform and Growth Incentive Provisions							
A. Reduction in Corporate Income Tax Rates:							
1. Corporate tax rate reductions for manufacturing and other specified income, including maximum 34% rate for 2004 through 2006, and 32% for 2007 and thereafter [1]..	tyba 12/31/03	−1,378	−2,112	−3,600	−5,658	−6,253	−19,001
2. 33% corporate income tax rate applies to taxable income over $75,000 and under $1 million in 2004 through 2006; 32% corporate income tax rate applies to taxable income over $75,000 and under: $1 million in 2007 and 2008, $5 million in 2009 through 2011, and $20 million thereafter for non-manufacturing income [1].	tyba 12/31/03	−353	−627	−757	−1,030	−1,150	−3,917
B. Two-Year Extension of Increased Expensing for Small Business—increase section 179 expensing 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 extend indexing of both the deduction limit and the phaseout threshold (sunset after 2007).	tyba 12/31/05	....	....	−3,833	−6,832	−899	−11,564
C. Recovery Period for Depreciation of Certain Leasehold Improvements and Restaurant Property:							
1. 15-year straight-line cost recovery for qualified leasehold improvements (sunset after 2005)	ppisa DOE	−59	−148	−245	−276	−267	−995
2. 15-year straight-line cost recovery for qualified restaurant improvements (sunset after 2005)	ppisa DOE	−300	−174	−28	−33	−33	−568
D. Alternative Minimum Tax Relief:							
1. Repeal the 90% limitation on the use of foreign tax credits against the AMT	tyba 12/31/04	....	−236	−355	−338	−334	−1,263
2. Phaseout 90% limitation on use of net operating losses (92% in 2005 through 2007, 94% in 2008 and 2009, 96% in 2010, 98% in 2011, and 100% in 2012 and thereafter).	tyba 12/31/04	....	−116	−175	−171	−310	−773
3. Expansion of exemption from alternative minimum tax for small corporations to $20 million ..	tyba 12/31/04	....	−105	−136	−118	−113	−472
4. Coordinate farmer income averaging and the alternative minimum tax	tyba 12/31/02	−2	−2	−2	−3	−4	−13
E. S Corporation Reform and Simplification:							
1. Treat members of family as one shareholder (3 generations, without limit) (includes interaction with line 2 below).	generally tyba 12/31/03	−1	−3	−4	−6	−7	−21
2. Increase in number of eligible shareholders to 100	tyba 12/31/03	−17	−42	−54	−64	−72	−250
3. Expansion of bank S corporation eligible shareholders to include IRAs	DOE	−16	−33	−34	−36	−37	−156
4. Disregard unexercised powers of appointment in determining potential current beneficiaries of ESBT.	tyba 12/31/03	Negligible Revenue Effect					
5. Use of passive activity loss by subchapter S trust income beneficiaries	tma 12/31/03	−1	−1	−1	−1	−1	−4
6. Transfer of suspended losses incident to divorce	tyba 12/31/03	−1	−2	−2	−2	−2	−10
7. Exclusion of investment securities income from passive income test for bank S corporations		Negligible Revenue Effect					
8. Treatment of bank director shares	tyba 12/31/03	−4	−10	−13	14	−15	−56
9. Relief from inadvertently invalid qualified subchapter S subsidiary elections and terminations	tyba 12/31/03	−1	−1	−1	−1	−1	−7
10. Information retiurns for qualified subchapter S subsidiaries	tyba 12/31/03	No Revenue Effect					

ESTIMATED BUDGET EFFECTS OF H.R. 2896, THE ''AMERICAN JOBS CREATION ACT OF 2003,'' AS REPORTED BY THE COMMITTEE ON WAYS AND MEANS—Continued

[Fiscal years 2004–2008, in millions of dollars]

Provision	Effective	2004	2005	2006	2007	2008	2004–08
11. Repayment of loan for qualifying employer securities	dma 12/31/03	(2)	(2)	(2)	(2)	(2)	−2
F. Employee Benefits:							
1. treatment of nonqualified deferred compensation plans	(3)	137	160	91	31	15	433
2. Exclusion of incentive stock options and employee stock purchase plan stock options from wages.	saptoea DOE			No Revenue Effect			
3. Extend provision under section 420 permitting qualified transfers of excess defined benefit permitting qualified transfers of excess defined pension plan assets to section 401(h) accounts (through 12/31/13.	DOE	....	....	18	38	40	97
G. Treatment of Active Income:							
1. Treat European Union as one country for certain purposes of subpart F	(4)	....	....	....	....	....	....
2. Look-through treatment of payments between related CFCs under foreign personal holding company income rules.	(5)	....	....	....	−83	−235	−318
3. Look-through treatment for sales of partnership interests	(5)	....	....	....	−43	−101	−144
4. Repeal of foreign personal holding company rules and foreign investment company rules	(5)	....	....	....	−31	−81	−112
5. Treatment of pipeline transportation income	(6)	....	−1	−7	−9	−11	−28
6. Determination of foreign personal holding company income with respect to transactions in commodities.	teia 12/31/04	....	−4	−10	−10	−10	−34
7. Repeal of CFC rules on foreign base company shipping income [7]	(6)	....	−6	−42	−52	−64	−164
8. Modification of exceptions under subpart F for active financing income	(6)			Negligible Revenue Effect			
9. Partial exclusion for foreign-source royalties from certain film-related intangibles	tyea 12/31/06	....	....	(2)	−2	−14	−16
H. Reduction in Double Taxation of Corporate Earnings:							
1. Interest expense allocation rules	tyba 12/31/08	....	....	....	....	....	....
2. Recharacterization of overall domestic loss	isf tyba 12/31/05	....	....	−54	−647	−680	−1,381
3. Reduction to 2 foreign tax credit baskets [8]	tyba 12/31/04	....	−557	−749	−824	−900	−3,030
4. Look-through rules to apply to dividends from noncontrolled section 902 corporations	tyba 12/31/02	−585	−77	−51	−23	−6	−742
5. Attribution of stock ownership through partnerships to apply in determining section 902 and 960 credits.	tyba DOE	....	−1	−3	−3	−3	−10
6. Clarification of treatment of certain transfers of intangible property	aro/a 8/5/97	−22	−4	−5	−5	−5	−41
7. United States property not to include certain assets acquired by dealers in ordinary course of trade or business.	(6)	....	−1	−12	−12	−12	−37
8. Election not to use average exchange rate for foreign tax paid other than in functional currency.	tyb 12/31/04			Negligible Revenue Effect			
9. Repeal of withholding tax on dividends from certain foreign corporations	pma 12/31/04	....	(2)	−3	−3	−3	−11
10. Provide equal treatment for interest paid by foreign partnerships and foreign corporations doing business in the U.S..	tyba 12/31/03	−1	−2	−2	−2	−2	−9

11. Treatment of certain dividends of regulated investment companies	(9)	−14	−38	−59	−61	−63	−235
12. Interaction			217	238	263	313	1,031
I. Other Provisions:							
1. Special rules for livestock sold on account of weather-related conditions—increase reinvestment period from 2 to 4 years for involuntary conversion of livestock due to drought, flood, or other weather-related conditions.	trda 12/31/02		−18	−7	−4	−3	−32
2. Payment of dividends on stock of cooperatives without reducing patronage dividends	dmi tyba DOE	(2)	(2)	−1	−1	−1	−3
3. Add hepatitis A to the list of taxable vaccines	(10)	6	9	9	9	9	42
4. Expand human clinical trials expenses qualifying for the orphan drug tax credit	eia DOE	−10	−16	−16	−17	−18	−77
5. Distributions from publicly traded partnerships treated as qualifying income for regulated investment company.	tyba DOE	−1	−3	−4	−5	−6	−19
6. Real estate investment trust modification provisions	tyba 12/31/00 & tyba DOE			Negligible Revenue Effect			
7. Simplification of excise tax imposed on bows and arrows [11]	asbmpoia 12/31/03	−1	−1	−1	−1	−1	−3
8. Repeal excise tax on fishing tackle boxes [11]	asbmpoia 12/31/03	−3	−3	−3	−3	−3	−12
9. Income tax credit for cost of carrying tax-paid distilled spirits in wholesale inventories	tyba 12/31/03	−12	−18	−19	−19	−20	−88
10. Capital gains treatment to apply to outright sales of timber by landowner	sota 12/31/03			Negligible Revenue Effect			
11. Repeal excise tax on sonar devices suitable for finding fish [11]	asbmpoia 12/31/03	(2)	(2)	(2)	(2)	(2)	−2
12. Taxation of certain settlement funds	tyba 12/31/03	−4	−6	−6	−6	−7	−29
13. Suspension of the occupational taxes relating to distilled spirits, wine, and beer (sunset 6/30/07).	DOE	−66	−78	−78	−12		−234
Total of Corporate Reform and Growth Incentive Provisions		−2,709	−4,062	−10,016	−16,120	−11,370	−44,280
Provisions to Reduce Tax Avoidance Through Corporate Earnings Stripping and Expatriation							
1. Reduction in potential for earnings stripping by further limiting deduction for interest on certain indebtedness (eliminate debt/equity safe harbor, use 35% generally for pre-2005 and 25% for post-2004 debt and 50% for guaranteed debt, or elect 30% for all post-2004 debt, eliminate excess limit carryforward, and change excess interest carryforward period for net interest expense/ATI test to 10 years).	(12)	61	65	142	288	318	874
2. Tax treatment of expatriated entities	tyea 3/4/03	27	19	24	28	30	128
3. 15% excise tax on stock compensation of insiders in expatriated corporations	(13)	11	7	7	7	7	38
4. Reinsurance of United States risks in foreign jurisdictions	rra DOE	(14)	(14)	(14)	(14)	(14)	2
5. Revision of tax rules for individuals who expatriate	iwea 2/27/03	19	18	21	24	28	110
6. Reporting of taxable mergers and acquisitions	aaDOE	1	2	3	3	3	12
7. Studies	DOE			No Revenue Effect			
Total of Provisions to Reduce Tax Avoidance Through Corporate Earnings Stripping and Expatriation.		119	111	197	350	386	1,164

ESTIMATED BUDGET EFFECTS OF H.R. 2896, THE ''AMERICAN JOBS CREATION ACT OF 2003,'' AS REPORTED BY THE COMMITTEE ON WAYS AND MEANS—Continued

[Fiscal years 2004–2008, in millions of dollars]

Provision	Effective	2004	2005	2006	2007	2008	2004–08
Provisions Relating to Tax Shelters and Miscellaneous Other Provisions:							
A. Tax Shelter Provisions:							
1. Provisions relating to reportable transactions and tax shelters	various dates after DOE[15]	92	115	119	120	124	570
2. Modifications to the substantial understatement penalty for nonreportable transactions	tyba DOE	....	4	11	19	23	57
3. Modification of actions to enjoin certain conduct related to tax shelters and reportable transactions.	da DOE			Negligible Revenue Effect			
4. Impose a civil penalty (of up to $5,000) on failure to report interest in foreign financial accounts.	voa DOE	....	[14]	[14]	[14]	[14]	1
5. Regulation of individuals practicing before the Department of Treasury	ata DOE			No Revenue Effect			
B. Other Provisions:							
1. Treatment of stripped interest in bond and preferred stock funds	pada DOE	2	13	11	8	5	39
2. Minimum holding period for foreign tax credit on withholding tax on income other than dividends.	apoamt 30da DOE	[14]	3	3	3	3	12
3. Disallowance of certain partnership loss transfers	ctada DOE	18	39	57	70	79	264
4. No reduction of basis under section 734 in stock held by partnership in corporate partner	Da DOE	5	13	20	28	36	101
5. Repeal of special rules for FASITs	tyba 12/31/03			Negligible Revenue Effect			
6. Limitation on transfer of built-in losses on REMIC residuals	ta DOE	[14]	2	4	6	8	20
7. Clarification of banking business for purposes of determining investment of earnings in United States property.	DOE	....	7	13	14	16	50
8. Modify rules related to certain small property and casualty insurance companies—reform of section 501(c)(15) to apply to organizations with gross receipts not exceeding $600,000 and premiums greater than 50% of gross receipts; increase the net-written-premium threshold permitting certain small insurance companies to be taxed on investment income to $1.89 million and index for inflation.	tyba 12/31/03	45	98	111	117	122	492
9. Modification of definition of insurance companies other than life insurance companies	tyba 12/31/03	1	2	2	2	2	11
10. Deny deduction for interest paid to the IRS on underpayments involving certain tax motivated transactions.	tyba DOE	....	....	1	1	3	5
11. Clarification of rules for payment of estimated tax for certain deemed asset sales	toa DOE	51	37	10	3	3	104
12. Exclusion of like-kind exchange property from nonrecognition treatment on the sale or exchange of a principal residence.	sopra DOE	[14]	11	13	15	17	56
13. Prevent mismatching of deductions and income inclusions in transactions with related foreign persons.	pao/a DOE	12	41	84	79	33	249
14. Exclusion from gross income for interests on overpayments of income tax by individuals	iri cyba DOE	....	1,034	−103	−106	−109	716

15. Deposits made to suspend the running of interest on potential underpayments	Dma DOE	157	−5	−6	−6	−6	134
16. Authorize IRS to enter into installment agreements that provide for partial payment	iaeio/a DOE	48	14	5	([16])	([16])	67
17. Extension of IRS user fees (through 9/30/13)	DOE	....	25	35	36	38	135
Provisions Relating to Tax Shelters and Miscellaneous Other Provisions	....	431	1,453	390	409	397	3,083
Trade Enhancement and Compliance Provisions							
1. Repeal of exclusion for extraterritorial income	([17])	453	880	1,436	3,636	5,490	11,895
2. Extend Customs User Fees:	....	....	....	....	....	....	....
a. Passenger and conveyance processing fee (through 12/31/13) [18 19]	DOE	....	108	329	346	363	1,146
b. Merchandise processing fee (through 12.31.13) [18 19]	DOE	....	671	1,216	1,286	1,359	4,532
Total of Trade Enhancement and Compliance Provisions	....	453	1,659	2,981	5,268	7,212	17,573
Net Total	....	−1,706	−839	−6,448	−10,093	−3,375	−22,460

[1] Overlap between the two rate reduction proposals (items A.1. and A.2.) is reflected in A.1.

[2] Loss of less than $500,000.

[3] Effective for amounts in taxable years beginning after December 31, 2003, except for amounts deferred in 2004 pursuant to an irrevocable election made prior to October 24, 2003.

[4] Effective for taxable years of foreign corporations beginning after December 31, 2008, and for taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

[5] Effective for taxable years of foreign corporations beginning after December 31, 2006, and for taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

[6] Effective for taxable years of foreign corporations beginning after December 31, 2004, and for taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

[7] Estimate accounts for interaction with reduction to 2 foreign tax credit baskets in item H.3.

[8] Pre-effective date excess credits carried forward to new basket that would apply under new system.

[9] Effective for dividends with respect to taxable years of regulated investment companies beginning after the date of enactment.

[10] Effective for vaccines sold beginning on the first day of the first month beginning more than four weeks after the date of enactment.

[11] Provision will have partially offsetting effects on outlays which will be provided by the Congressional Budget Office.

[12] Effective for taxable years beginning after 2003, and taxable years ending after March 4, 2003, for ''surrogate'' corporations with lookback to December 31, 1996.

[13] Generally effective March 4, 2003.

[14] Gain of less than $1 million.

[15] Effective dates for provisions relating to reportable transactions and tax shelters: the penalty for failure to disclose reportable transactions is effective for returns and statements the due date of which is after the date of enactment; the modification to the accuracy-related penalty for listed or reportable transactions is effective for taxable years ending after the date of enactment; the tax shelter exception to confidentiality privileges is effective for communications made on or after the date of enactment; the statute of limitations for unreported listed transactions applies to all taxable years for which the statute of limitations under section 6501 has not run as of the date of enactment; the disclosure of reportable transactions by material advisors is effective for transactions with respect to which material aid, assistance or advice is provided after the date of enactment; the investor list penalty is effective for returns the due date for which is after the date of enactment; the modification of penalty for failure to maintain investor lists is effective for requests made after the date of enactment; and the penalty on promoters of tax shelters is effective for activities after the date of enactment.

[16] Gain of less than $500,000.

[17] Generally effective for transactions after 2003, with transition for transactions during 2004 through 2006.

[18] Estimate is subject to review by the Congressional Budget Office.

[19] Estimate reflects enactment of H.R. 3365, the ''Military Family Tax Relief Act of 2003.''

Legend for ‘‘Effective’’ column: aa=acquisitions after; apoamt=amounts paid or accrued more than; aro/a=amounts received on or after; asbmpoia=articles sold by the manufacturer, producer, or importer after; ata=actions taken after; ctada=contributions, transfers, and distributions after; cyba=calendar years beginning after; da=day after; Da=distributions after; dma=distributions made after; Dma=deposits made after; DOE=date of enactment; dmi=distributions made in; iwea=individuals who expatriate after; eia=expenses incurred after; iaeio/a=installment agreements entered into on or after; iri=interest received in; lsf=losses sustained for; pa=periods after; pada=purchases and dispositions after; pao/a=payments accrued on or after; pma=payments made after; ppisa=property placed in service after; rra=risk reinsured after; saptoea=stock acquired pursuant to options exercised after; sopra=sales of principal residences after; sota=sales of timber after; ta=transactions after; teia=transactions entered into after; tma=transfers made after; toa=transactions occurring after; trda=tax returns due after; tyba=taxable years beginning after; tyea=taxable years ending after; voa=violations occurring after; and 30da=30 days after.

Note.—Details may not add to totals due to rounding.

Source: Joint Committee on Taxation.

B. STATEMENT REGARDING NEW BUDGET AUTHORITY AND TAX EXPENDITURES BUDGET AUTHORITY

In compliance with clause 3(c)(2) of rule XIII of the Rules of the House of Representatives, the Committee states that the bill involves no new or increased budget authority. The Committee further states that the revenue reducing income tax provisions involve increased tax expenditures, and the revenue increasing provisions involve reduced tax expenditures (See amounts in table in Part IV.A., above.)

C. COST ESTIMATE PREPARED BY THE CONGRESSIONAL BUDGET OFFICE

In compliance with clause 3(c)(3) of rule XIII of the Rules of the House of Representatives, requiring a cost estimate prepared by the CBO, the following statement by CBO is provided.

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, November 5, 2003.

Hon. WILLIAM "BILL" M. THOMAS,
Chairman, Committee on Ways and Means,
House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: The Congressional Budget Office has prepared the enclosed cost estimate for H.R. 2896, the American Jobs Creation Act of 2003.

If you wish further details on this estimate, we will be pleased to provide them. The CBO staff contact is Annabelle Bartsch.

Sincerely,

ELIZABETH M. ROBINSON
(For Douglas Holtz-Eakin, Director).

Enclosure.

H.R. 2896—American Jobs Creation Act of 2003

Summary: H.R. 2896 would repeal the exclusion for extraterritorial income, institute a reduced tax rate on certain corporate income, and make numerous other changes to existing tax law relating to corporations. In addition, H.R. 2896 would extend IRS and customs user fees. The tax provisions of the bill would generally take effect after December 31, 2003.

The Congressional Budget Office (CBO) and the Joint Committee on Taxation (JCT) estimate that enacting the bill would reduce federal revenues by about $1.7 billion in 2004, $28.2 billion over the 2004–2008 period, and $76.6 billion over the 2004–2013 period. CBO estimates that the bill would decrease direct spending by $614 million in 2004, about $7 billion over the 2004–2008 period, and about $17.1 billion over the 2004–2013 period.

JCT has determined that the following tax provisions of H.R. 2896 contain private-sector mandates as defined in the Unfunded Mandates Reform Act (UMRA): (1) the provisions to reduce the potential for earnings stripping by further limiting the deduction for interest on certain indebtedness; (2) the provisions relating to reportable transactions and tax shelters; (3) the provision relating to the modification of the rules for certain property and casualty insurance companies; and (4) the provision to repeal the exclusion for extraterritorial income. CBO has reviewed the non-tax provisions and determined that the extension of the customs user fees is a private-sector mandate as defined in UMRA. In aggregate, the costs of those mandates would greatly exceed the annual threshold established by UMRA for private-sector mandates ($120 million in 2004, adjusted annually for inflation) in each of the first five years the mandates are in effect. JCT and CBO have determined that H.R. 2896 contains no intergovernmental mandates as defined in UMRA.

Estimated cost to the Federal Government: The estimated budgetary impact of H.R. 2896 is shown in the following table. The costs of the legislation fall within budget functions 300 (natural resources and environment), 550 (health), 750 (administration of justice), and 800 (general government).

	By fiscal year, in millions of dollars—									
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
CHANGES IN REVENUES										
Title I: Tax Provisions Relating to Corporate Tax Rates, Depreciation Rules, and to Other Changes	−2,709	−4,062	−10,016	−16,120	−11,370	−9,931	−15,467	−17,175	−20,031	−21,841
Title II: Provisions to Relating to Corporate Earnings Stripping and Expatriation	119	111	197	350	386	429	445	466	487	508
Title III: Provisions Relating to Tax Shelters and Other Miscellaneous Provisions	441	1,448	382	401	392	428	459	492	525	556
Title IV: Trade and Compliance Provisions	453	880	1,436	3,636	5,490	5,714	5,983	6,253	6,515	6,787
Estimated Revenues	−1,696	−1,623	−8,001	−11,733	−5,102	−3,360	−8,580	−9,964	−12,504	−13,990
CHANGES IN DIRECT SPENDING										
Taxation of Hepatitis A Vaccine:										
Estimated Budget Authority	5	7	7	7	7	7	7	7	7	7
Estimated Outlays	5	7	7	7	7	7	7	7	7	7
Reduction of Certain Excise Taxes:										
Estimated Budget Authority	0	−4	−4	−4	−4	−4	−4	−5	−5	−5
Estimated Outlays	0	−1	−2	−4	−4	−4	−4	−4	−5	−5
Installment Agreements for Tax Payments:										
Estimated Budget Authority	*	*	*	*	*	*	*	*	*	*
Estimated Outlays	*	*	*	*	*	*	*	*	*	*
Extension of Customs User Fees:										
Estimated Budget Authority	−619	−1,464	−1,546	−1,632	−1,722	−1,818	−1,919	−2,025	−2,138	−2,257
Estimated Outlays	−619	−1,464	−1,546	−1,632	−1,722	−1,818	−1,919	−2,025	−2,138	−2,257
Total Changes in Direct Spending:										
Estimated Budget Authority	−614	−1,461	−1,543	−1,629	−1,719	−1,815	−1,916	−2,023	−2,136	−2,255
Estimated Outlays	−614	−1,458	−1,541	−1,629	−1,719	−1,815	−1,916	−2,022	−2,136	−2,255
CHANGES IN SPENDING SUBJECT TO APPROPRIATION										
Extension of IRS User Fees:										
Estimated Authorization Level	0	3	4	4	4	4	4	4	4	
Estimated Outlays	0	3	4	4	4	4	4	4	4	

Notes:—Positive (negative) changes in revenues correspond to decreases (increases) in budget deficits. Positive (negative) changes in direct spending correspond to increases (decreases) in budget deficits.
* = increase of less than $500,000.
Sources: CBO and the Joint Committee on Taxation.

Basis of estimate

Revenues

With the exception of the extension of IRS user fees, JCT provided all the revenue estimates. All together, CBO and JCT estimate that the provisions contained in H.R. 2896 would reduce federal revenues by about $1.7 billion in 2004, $28.2 billion over the 2004–2008 period, and $76.6 billion over the 2004–2013 period. The largest budgetary effects would result from repealing the exclusion for extraterritorial income and instituting a reduced tax rate on certain corporate income.

Title I of H.R. 2896 would alter numerous provisions of tax law for corporations. In total, JCT estimates enacting the provisions of title I would reduce federal revenues by about $2.7 billion in 2004, $44.3 billion over the 2004–2008 period, and $128.7 billion over the 2004–2013 period. A large portion of this reduction would come from lowering the tax rate on corporations for income from certain manufacturing and nonmanufacturing activities, which JCT estimates would decrease governmental receipts by about $1.7 billion in 2004, $22.9 billion over the 2004–2008 period, and $77.5 billion over the 2004–2013 period. Some of the other provisions in title I would extend increased expensing for small businesses for two years, alter depreciation rules, and modify the alternative minimum tax. Title I also would add Hepatitis A to the list of taxable vaccines, which would also affect direct spending (see "Direct Spending" section).

The provisions of title II would increase federal revenues by reducing tax avoidance through corporate earnings stripping and expatriation. In total, JCT estimates that these provisions would raise governmental receipts by $119 million in 2004, about $1.2 billion over the 2004–2008 period, and about $3.5 billion over the 2004–2013 period. Over half of the total increase would result from further limiting interest deductions on certain indebtedness in order to curb corporate earnings stripping.

The provisions of title III also would raise federal revenues over the next ten years. JCT estimates that modifying existing tax law relating to tax shelters and reportable and nonreportable transactions would increase revenues by $92 million in 2004, $628 million over the 2004–2008 period, and about $1.6 billion over the 2004–2013 period. Another provision of title III would extend IRS user fees through September 30, 2013. Currently, the fees are set to expire on December 31, 2004. CBO estimates this would increase revenues by $135 million over the 2005–2008 period and $345 million over the 2005–2013 period. In addition, the provisions include authorizing the IRS to enter into installment agreements for tax payments, which also would affect direct spending (see "Direct Spending" section). In total, CBO and JCT estimate that title III would increase governmental receipts by $441 million in 2004, about $3.1 billion over the 2004–2008 period, and about $5.5 billion over the 2004–2013 period.

Title IV of the bill would repeal the exclusion for extraterritorial income, including a transition period through 2006. JCT estimates doing so would increase federal revenues by about $453 million in 2004, by about $11.9 billion over the 2004–2008 period, and by about $43.1 billion over the 2004–2013 period.

Direct spending

In total, CBO estimates that the bill would decrease direct spending by $614 million in 2004, by about $7 billion over the 2004–2008 period, and by about $17.1 billion over the 2004–2013 period. In addition, CBO estimates H.R. 2896 would increase spending by $15 million over the 2004–2008 period and $36 million over the 2004–2013 period, subject to the appropriation of the estimated amounts.

Taxation of Hepatitis A Vaccine. The Hepatitis A vaccine tax provision (section 1103) would require vaccine buyers to pay an excise tax on each dose purchased. Medicaid is a major purchaser of vaccines through the Vaccines for Children program, administered through the Centers for Disease Control and Prevention (CDC). CBO assumes that Medicaid purchases approximately half of the Hepatitis A vaccines sold annually. Based on estimates provided by JCT, CBO expects that implementing section 1103 would cost the Medicaid program about $47 million over the 2004–2013 period.

Receipts from the tax would go to the Vaccine Injury Compensation Fund (VICF), which is administered by the Health Resources and Services Administration (HRSA). The fund uses tax revenues to pay compensation to claimants injured by vaccines. Once a vaccine becomes taxable, injuries attributed to its use become compensable through this fund. Based on information provided by HRSA and CDC, we assume there will be few compensable claims related to the Hepatitis A vaccine. CBO estimates the provision would increase outlays from the VICF by $21 million over the 2004–2013 period.

Reducing Certain Excise Taxes. Reducing excise taxes on certain hunting and fishing equipment would reduce deposits to the federal aid-wildlife fund and the aquatic resources trust fund. The loss of this income (and related interest earnings to the two funds) would result in lower spending for fish and wildlife conservation projects beginning in fiscal year 2005. CBO estimates that the resulting savings would be about $33 million over the 2005–2013 period.

Installment Agreements for Tax Payments. Section 3036 would allow the IRS to enter into agreements for the partial payment of tax liabilities. Under current law taxpayers can elect to pay their full tax liability through installments. The IRS charges a fee of $43 for each installment agreement, which it can retain and spend without further appropriation action. CBO estimates that allowing for the partial payment of tax liabilities would increase direct spending by about $1 million over the 2004–2013 period.

Extension of Customs User Fees. Under current law, customs user fees expire after March 31, 2004. H.R. 2896 would extend these fees through September 30, 2013. CBO estimates that this would increase offsetting receipts by about $17.1 billion over the 2004–2013 period.

Spending subject to appropriation

Extension of IRS User Fees. Section 3037 would extend the authority of the IRS to charge taxpayers fees for certain rulings, opinion letters, and determinations through September 30, 2013. The bill would authorize the IRS to retain and spend a portion of the fees collected, subject to appropriation. Based on the historical level of fees spent, CBO estimates that implementing this provision would cost $15 million over the 2005–2008 period and $36 million over the 2005–2013 period, subject to the appropriation of the estimated amounts.

Estimated impact on state, local, and tribal governments: JCT and CBO have reviewed the provisions of H.R. 2896 and have determined that the bill contains no intergovernmental mandates as defined in UMRA and would not affect the budgets of state, local, and tribal governments.

Estimated impact on the private sector: JCT has determined that the following tax provisions of H.R. 2896 contain private-sector mandates as defined in UMRA: (1) the provisions to reduce the potential for earnings stripping by further limiting the deduction for interest on certain indebtedness; (2) the provisions relating to reportable transactions and tax shelters; (3) the provision relating to the modification of the rules for certain property and casualty insurance companies; and (4) the provision to repeal the exclusion for extraterritorial income. In aggregate, the costs of those mandates would greatly exceed the annual threshold established by UMRA for private-sector mandates ($120 million in 2004, adjusted annually for inflation).

CBO has reviewed the non-tax provisions of H.R. 2896 and determined that the extension of the customs user fees is a private-sector mandate as defined in UMRA. H.R. 2896 would extend through 2013 customs user fees that are scheduled to expire at the end of March 2004 under current law. CBO cannot determine the direct cost of this provision, however, because UMRA does not clearly specify how to calculate the cost associated with extending an existing mandate that has not yet expired. Under one interpretation, UMRA requires the direct cost to be measured relative to a case that assumes that the current mandate will not exist beyond its current expiration date. Under that interpretation, CBO estimates that the direct cost of the mandate would be more than $600 million in 2004 and larger in later years. Under the other interpretation, UMRA requires the direct cost to be measured relative to the mandate currently in effect. Under that interpretation, the direct cost of this provision would be zero.

Estimate prepared by: Federal Revenues: Annabelle Bartsch. Federal Spending: Excise Taxes on Fishing and Hunting Equipment: Deborah Reis; Installment Agreements and IRS User Fees: Matthew Pickford; Hepatitis A Vaccine: Tom Bradley; and Customs User Fees: Mark Grabowicz. Impact on State, Local, and Tribal Governments: Melissa Merrell. Impact on the Private Sector: Patrice Gordon and Paige Piper/Bach.

Estimate approved by: G. Thomas Woodward, Assistant Director for Tax Analysis and Peter H. Fontaine, Deputy Assistant Director for Budget Analysis.

D. Macroeconomic Impact Analysis

In compliance with clause 3(h)(2) of rule XIII of the Rules of the House of Representatives, the following statement is made by the Joint Committee on Taxation with respect to the provisions of the bill amending the Internal Revenue Code of 1986: the effects of the bill on total economic activity within the ten-year budget horizon are so small as to be incalculable within the context of a model of the aggregate economy.

V. OTHER MATTERS TO BE DISCUSSED UNDER THE RULES OF THE HOUSE

A. Committee Oversight Findings and Recommendations

With respect to clause 3(c)(1) of rule XIII of the Rules of the House of Representatives (relating to oversight findings), the Committee advises that it was a result of the Committee's oversight review concerning the tax burden on American taxpayers that the Committee concluded that it is appropriate and timely to enact the revenue provisions included in the bill as reported.

B. Statement of General Performance Goals and Objectives

With respect to clause 3(c)(4) of rule XIII of the Rules of the House of Representatives, the Committee advises that the bill contains no measure that authorizes funding, so no statement of general performance goals and objectives for which any measure authorizes funding is required.

C. Constitutional Authority Statement

With respect to clause 3(d)(1) of the rule XIII of the Rules of the House of Representatives (relating to Constitutional Authority), the Committee states that the Committee's action in reporting this bill is derived from Article I of the Constitution, Section 8 ("The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises * * *"), and from the 16th Amendment to the Constitution.

D. Information Relating to Unfunded Mandates

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

The Committee has determined that the bill contains four Federal mandates on the private sector: (1) the provision to reduce the potential for earnings stripping by further limiting the deduction for interest on certain indebtedness; (2) the provision relating to reportable transactions and tax shelters; (3) the provision relating to modification of the rules for certain property and casualty insurance companies; and (4) the provision to repeal the exclusion for extraterritorial income. The costs required to comply with each Federal private sector mandate generally are no greater than the aggregate estimated budget effects of the provision. Benefits from the provision include improved administration of the tax laws and a more accurate measurement of income for Federal tax purposes.

The Committee has determined that the bill does not impose a Federal intergovernmental mandate on State, local, or tribal governments.

E. Applicability of House Rule XXI 5(b)

Rule XXI 5(b) of the Rules of the House of Representatives provides, in part, that "A bill or joint resolution, amendment, or conference report carrying a Federal income tax rate increase may not be considered as passed or agreed to unless so determined by a vote of not less than three-fifths of the Members voting, a quorum being present." The Committee has carefully reviewed the provisions of the bill, and states that the provisions of the bill do not involve any Federal income tax rate increases within the meaning of the rule.

F. Tax Complexity Analysis

Section 4022(b) of the Internal Revenue Service Reform and Restructuring Act of 1998 (the "IRS Reform Act") requires the Joint Committee on Taxation (in consultation with the Internal Revenue Service and the Department of the Treasury) to provide a tax complexity analysis. The complexity analysis is required for all legislation reported by the House Committee on Ways and Means, the Senate Committee on Finance, or any committee of conference if the legislation includes a provision that directly or indirectly amends the Internal Revenue Code and has widespread applicability to individuals or small businesses.

The staff of the Joint Committee on Taxation has determined that a complexity analysis is not required under section 4022(b) of the IRS Reform Act because the bill contains no provisions that amend the Internal Revenue Code and that have "widespread applicability" to individuals or small businesses.

VI. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3(e) of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italic, existing law in which no change is proposed is shown in roman):

INTERNAL REVENUE CODE OF 1986

* * * * * * *

Subtitle A—Income Taxes

* * * * * * *

CHAPTER 1—NORMAL TAXES AND SURTAXES

* * * * * * *

Subchapter A—Determination of Tax Liability

* * * * * * *

PART I—TAX ON INDIVIDUALS

* * * * * * *

SEC. 1. TAX IMPOSED.

(a) * * *

* * * * * * *

(h) Maximum Capital Gains Rate.—

(1) * * *

* * * * * * *

(11) DIVIDENDS TAXED AS NET CAPITAL GAIN.—

(A) * * *

* * * * * * *

(C) QUALIFIED FOREIGN CORPORATIONS.—

(i) * * *

* * * * * * *

(iii) EXCLUSION OF DIVIDENDS OF CERTAIN FOREIGN CORPORATIONS.—Such term shall not include any foreign corporation which for the taxable year of the corporation in which the dividend was paid, or the preceding taxable year, is ⟦a foreign personal holding company (as defined in section 552), a foreign investment company (as defined in section 1246(b)), or⟧ a passive foreign investment company (as defined in section 1297).

* * * * * * *

PART II—TAX ON CORPORATIONS

* * * * * * *

SEC. 11. TAX IMPOSED.

(a) * * *

(b) AMOUNT OF TAX.—

⟦(1) IN GENERAL.—The amount of the tax imposed by subsection (a) shall be the sum of—

⟦(A) 15 percent of so much of the taxable income as does not exceed $50,000,

⟦(B) 25 percent of so much of the taxable income as exceeds $50,000 but does not exceed $75,000,

⟦(C) 34 percent of so much of the taxable income as exceeds $75,000 but does not exceed $10,000,000, and

⟦(D) 35 percent of so much of the taxable income as exceeds $10,000,000.

In the case of a corporation which has taxable income in excess of $100,000 for any taxable year, the amount of tax determined under the preceding sentence for such taxable year shall be increased by the lesser of (i) 5 percent of such excess, or (ii) $11,750. In the case of a corporation which has taxable income in excess of $15,000,000, the amount of the tax determined under the foregoing provisions of this paragraph shall be increased by an additional amount equal to the lesser of (i) 3 percent of such excess, or (ii) $100,000.⟧

(1) FOR TAXABLE YEARS BEGINNING AFTER 2011.—In the case of taxable years beginning after 2011, the amount of the tax imposed by subsection (a) shall be determined in accordance with the following table:

If taxable income is:	***The tax is:***
Not over $50,000	*15% of taxable income.*
Over $50,000 but not over $75,000	*$7,500, plus 25% of the excess over $50,000.*
Over $75,000 but not over $20,000,000	*$13,750, plus 32% of the excess over $75,000.*

If taxable income is:	*The tax is:*
Over $20,000,000	*$6,389,750, plus 35% of the excess over $20,000,000.*

(2) FOR TAXABLE YEARS BEGINNING IN 2009, 2010, OR 2011.—In the case of taxable years beginning in 2009, 2010, or 2011, the amount of the tax imposed by subsection (a) shall be determined in accordance with the following table:

If taxable income is:	*The tax is:*
Not over $50,000	*15% of taxable income.*
Over $50,000 but not over $75,000	*$7,500, plus 25% of the excess over $50,000.*
Over $75,000 but not over $5,000,000	*$13,750, plus 32% of the excess over $75,000.*
Over $5,000,000 but not over $10,000,000.	*$1,589,750, plus 34% of the excess over $5,000,000.*
Over $10,000,000	*$3,289,750, plus 35% of the excess over $10,000,000.*

(3) FOR TAXABLE YEARS BEGINNING IN 2007 OR 2008.—In the case of taxable years beginning in 2007 or 2008, the amount of the tax imposed by subsection (a) shall be determined in accordance with the following table:

If taxable income is:	*The tax is:*
Not over $50,000	*15% of taxable income.*
Over $50,000 but not over $75,000	*$7,500, plus 25% of the excess over $50,000.*
Over $75,000 but not over $1,000,000	*$13,750, plus 32% of the excess over $75,000.*
Over $1,000,000 but not over $10,000,000.	*$309,750, plus 34% of the excess over $1,000,000.*
Over $10,000,000	*$3,369,750, plus 35% of the excess over $10,000,000.*

(4) FOR TAXABLE YEARS BEGINNING IN 2004, 2005, OR 2006.—In the case of taxable years beginning in 2004, 2005, or 2006, the amount of the tax imposed by subsection (a) shall be determined in accordance with the following table:

If taxable income is:	*The tax is:*
Not over $50,000	*15% of taxable income.*
Over $50,000 but not over $75,000	*$7,500, plus 25% of the excess over $50,000.*
Over $75,000 but not over $1,000,000	*$13,750, plus 33% of the excess over $75,000.*
Over $1,000,000 but not over $10,000,000.	*$319,000, plus 34% of the excess over $1,000,000.*
Over $10,000,000	*$3,379,000, plus 35% of the excess over $10,000,000.*

(5) PHASEOUT OF LOWER RATES FOR CERTAIN TAXPAYERS.—

(A) GENERAL RULE FOR YEARS BEFORE 2012.—

(i) IN GENERAL.—In the case of taxable years beginning before 2012 with respect to a corporation which has taxable income in excess of the applicable amount for any taxable year, the amount of tax determined under paragraph (1), (2), (3) or (4) for such taxable year shall be increased by the lesser of (I) 5 percent of such excess, or (II) the maximum increase amount.

(ii) MAXIMUM INCREASE AMOUNT.—For purposes of clause (i)—

In the case of any taxable year beginning during:	*The applicable amount is:*	*The maximum increase amount is:*
2004, 2005, or 2006	*$1,000,000*	*$21,000*

In the case of any taxable year beginning during:	*The applicable amount is:*	*The maximum increase amount is:*
2007 or 2008	*$1,000,000*	*$30,250*
2009, 2010, or 2011	*$5,000,000*	*$110,250.*

(B) HIGHER INCOME CORPORATIONS.—In the case of a corporation which has taxable income in excess of $20,000,000 ($15,000,000 in the case of taxable years beginning before 2012), the amount of the tax determined under the foregoing provisions of this subsection shall be increased by an additional amount equal to the lesser of (i) 3 percent of such excess, or (ii) $610,250 ($100,000 in the case of taxable years beginning before 2012).

[(2)**]** *(6)* CERTAIN PERSONAL SERVICE CORPORATIONS NOT ELIGIBLE FOR GRADUATED RATES.—Notwithstanding paragraph (1), the amount of the tax imposed by subsection (a) on the taxable income of a qualified personal service corporation (as defined in section 448(d)(2) shall be equal to 35 percent of the taxable income.

(c) LIMITATION ON TAX ON QUALIFIED PRODUCTION ACTIVITIES INCOME.—

(1) IN GENERAL.—If a corporation has qualified production activities income for any taxable year, the tax imposed by this section shall not exceed the sum of—

(A) a tax computed at the rates and in the manner as if this subsection had not been enacted on the taxable income reduced by the amount of qualified production activities income, plus

(B) a tax equal to 32 percent (34 percent in the case of taxable years beginning before January 1, 2007) of the qualified production activities income (or, if less, taxable income).

(2) QUALIFIED PRODUCTION ACTIVITIES INCOME.—

(A) IN GENERAL.—The term "qualified production activities income" for any taxable year means an amount equal to the excess (if any) of—

(i) the taxpayer's domestic production gross receipts for such taxable year, over

(ii) the sum of—

(I) the cost of goods sold that are allocable to such receipts,

(II) other deductions, expenses, or losses directly allocable to such receipts, and

(III) a ratable portion of other deductions, expenses, and losses that are not directly allocable to such receipts or another class of income.

(B) ALLOCATION METHOD.—The Secretary shall prescribe rules for the proper allocation of items of income, deduction, expense, and loss for purposes of determining income attributable to domestic production activities.

(3) DOMESTIC PRODUCTION GROSS RECEIPTS.—For purposes of this subsection, the term "domestic production gross receipts" means the gross receipts of the taxpayer which are derived from—

(A) any lease, rental, license, sale, exchange, or other disposition of—

(i) qualifying production property which was manufactured, produced, grown, or extracted in whole or in significant part by the taxpayer within the United States, or

(ii) any qualified film produced by the taxpayer, or

(B) construction, engineering, or architectural services performed in the United States for construction projects in the United States.

(4) QUALIFYING PRODUCTION PROPERTY.—For purposes of this subsection, the term "qualifying production property" means—

(A) tangible personal property,

(B) any computer software, and

(C) any property described in section 168(f)(4).

(5) QUALIFIED FILM.—For purposes of this subsection—

(A) IN GENERAL.—The term "qualified film" means any property described in section 168(f)(3) if not less than 50 percent of the total compensation relating to the production of such property is compensation for services performed in the United States by actors, production personnel, directors, and producers.

(B) EXCEPTION.—Such term does not include property with respect to which records are required to be maintained under section 2257 of title 18, United States Code.

(6) RELATED PERSONS.—For purposes of this subsection—

(A) IN GENERAL.— The term "domestic production gross receipts" shall not include any gross receipts of the taxpayer derived from property leased, licensed, or rented by the taxpayer for use by any related person.

(B) RELATED PERSON.—For purposes of subparagraph (A), a person shall be treated as related to another person if such persons are treated as a single employer under subsection (a) or (b) of section 52 or subsection (m) or (o) of section 414, except that determinations under subsections (a) and (b) of section 52 shall be made without regard to section 1563(b).

⟦(c)⟧ *(d)* EXCEPTIONS.—Subsection (a) shall not apply to a corporation subject to a tax imposed by—

(1) * * *

* * * * * * *

⟦(d)⟧ *(e)* FOREIGN CORPORATIONS.—In the case of a foreign corporation, the taxes imposed by subsection (a) and section 55 shall apply only as provided by section 882.

* * * * * * *

PART IV—CREDITS AGAINST TAX

* * * * * * *

Subpart D—Business Related Credits

* * * * * * *

SEC. 38. GENERAL BUSINESS CREDIT.

(a) * * *

(b) CURRENT YEAR BUSINESS CREDIT.—For purposes of this subpart, the amount of the current year business credit is the sum of the following credits determined for the taxable year:

(1) * * *

* * * * * * *

(14) in the case of an eligible employer (as defined in section 45E(c)), the small employer pension plan startup cost credit determined under section 45E(a), [plus]

(15) the employer-provided child care credit determined under section 45F(a)[.]*, plus*

(16) in the case of an eligible wholesaler (as defined in section 5011(b)), the distilled spirits wholesaler credit determined under section 5011(a).

* * * * * * *

SEC. 39. CARRYBACK AND CARRYFORWARD OF UNUSED CREDITS.

(a) * * *

* * * * * * *

(d) TRANSITIONAL RULES.—

(1) * * *

* * * * * * *

(11) NO CARRYBACK OF SECTION 5011 CREDIT BEFORE JANUARY 1, 2004.—No portion of the unused business credit for any taxable year which is attributable to the credit determined under section 5011(a) may be carried back to a taxable year beginning before January 1, 2004.

* * * * * * *

SEC. 45C. CLINICAL TESTING EXPENSES FOR CERTAIN DRUGS FOR RARE DISEASES OR CONDITIONS.

(a) * * *

(b) QUALIFIED CLINICAL TESTING EXPENSES.—For purposes of this section—

(1) * * *

(2) CLINICAL TESTING.—

(A) * * *

* * * * * * *

(C) TREATMENT OF CERTAIN EXPENSES INCURRED BEFORE DESIGNATION.—For purposes of subparagraph (A)(ii)(I), if a drug is designated under section 526 of the Federal Food, Drug, and Cosmetic Act not later than the due date (including extensions) for filing the return of tax under this subtitle for the taxable year in which the application for such designation of such drug was filed, such drug shall be treated as having been designated on the date that such application was filed.

* * * * * * *

Subpart G—Credit Against Regular Tax for Prior Year Minimum Tax Liability

* * * * * * *

SEC. 53. CREDIT FOR PRIOR YEAR MINIMUM TAX LIABILITY.

(a) * * *

* * * * * * *

(d) DEFINITIONS.—For purposes of this section—

(1) NET MINIMUM TAX.—

(A) * * *

(B) CREDIT NOT ALLOWED FOR EXCLUSION PREFERENCES.—

(i) ADJUSTED NET MINIMUM TAX.—The adjusted net minimum tax for any taxable year is—

(I) * * *

(II) the amount which would be the net minimum tax for such taxable year if the only adjustments and items of tax preference taken into account were those specified in clause (ii) ⟦and if section 59(a)(2) did not apply⟧.

* * * * * * *

PART VI—MINIMUM TAX FOR TAX PREFERENCES

* * * * * * *

SEC. 55. ALTERNATIVE MINIMUM TAX IMPOSED.

(a) * * *

* * * * * * *

(c) REGULAR TAX.—

(1) * * *

(2) COORDINATION WITH INCOME AVERAGING FOR FARMERS.—Solely for purposes of this section, section 1301 (relating to averaging of farm income) shall not apply in computing the regular tax liability.

⟦(2)⟧ *(3)* CROSS REFERENCES.—

For provisions providing that certain credits are not allowable against the tax imposed by this section, see sections 26(a), 29(b)(6), 30(b)(3) and 38(c).

* * * * * * *

(e) EXEMPTION FOR SMALL CORPORATIONS.—

(1) IN GENERAL.—

(A) ⟦$7,500,000⟧ *$20,000,000* GROSS RECEIPTS TEST.—The tentative minimum tax of a corporation shall be zero for any taxable year if the corporation's average annual gross receipts for all 3-taxable-year periods ending before such taxable year does not exceed ⟦$7,500,000⟧ *$20,000,000*. For purposes of the preceding sentence, only taxable years beginning after December 31, 1993, shall be taken into account.

(B) $5,000,000 GROSS RECEIPTS TEST FOR FIRST 3-YEAR PERIOD.—Subparagraph (A) shall be applied by substituting "$5,000,000" for "⟦$7,500,000⟧ *$20,000,000*" for the first 3-taxable-year period (or portion thereof) of the corporation which is taken into account under subparagraph (A).

* * * * * * *

SEC. 56. ADJUSTMENTS IN COMPUTING ALTERNATIVE MINIMUM TAXABLE INCOME.

(a) * * *

* * * * * * *

(d) ALTERNATIVE TAX NET OPERATING LOSS DEDUCTION DEFINED.—

(1) IN GENERAL.—For purposes of subsection (a)(4), the term "alternative tax net operating loss deduction" means the net operating loss deduction allowable for the taxable year under section 172, except that—

[(A) the amount of such deduction shall not exceed the sum of—

[(i) the lesser of—

[(I) the amount of such deduction attributable to net operating losses (other than the deduction attributable to carryovers described in clause (ii)(I)), or

[(II) 90 percent of alternative minimum taxable income determined without regard to such deduction, plus

[(ii) the lesser of—

[(I) the amount of such deduction attributable to the sum of carrybacks of net operating losses for taxable years ending during 2001 or 2002 and carryforwards of net operating losses to taxable years ending during 2001 and 2002, or

[(II) alternative minimum taxable income determined without regard to such deduction reduced by the amount determined under clause (i), and]

(A) the amount of such deduction shall not exceed the applicable percentage (determined under paragraph (3)) of the alternative minimum taxable income determined without regard to such deduction, and

* * * * * * *

(3) APPLICABLE PERCENTAGE.—For purposes of paragraph (1)(A)—

For taxable years beginning in calendar year—	***The applicable percentage is—***
2005, 2006, or 2007	*92*
2008 or 2009	*94*
2010	*96*
2011	*98*
2012 or thereafter	*100.*

* * * * * * *

(g) ADJUSTMENTS BASED ON ADJUSTED CURRENT EARNINGS.—

(1) * * *

* * * * * * *

(6) EXCEPTION FOR CERTAIN CORPORATIONS.—This subsection shall not apply to any S corporation, regulated investment company, real estate investment trust, [REMIC, or FASIT] *or REMIC*.

* * * * * * *

SEC. 59. OTHER DEFINITIONS AND SPECIAL RULES.

(a) ALTERNATIVE MINIMUM TAX FOREIGN TAX CREDIT.—For purposes of this part—

(1) * * *

[(2) LIMITATION TO 90 PERCENT OF TAX.—

[(A) IN GENERAL.—The alternative minimum tax foreign tax credit for any taxable year shall not exceed the excess (if any) of—

[(i) the pre-credit tentative minimum tax for the taxable year, over

[(ii) 10 percent of the amount which would be the pre-credit tentative minimum tax without regard to the alternative tax net operating loss deduction and section 57(a)(2)(E).

[(B) CARRYBACK AND CARRYFORWARD.—If the alternative minimum tax foreign tax credit exceeds the amount determined under subparagraph (A), such excess shall, for purposes of this part, be treated as an amount to which section 904(c) applies.]

[(3)] *(2)* PRE-CREDIT TENTATIVE MINIMUM TAX.—For purposes of this subsection, the term "pre-credit tentative minimum tax" means—

(A) * * *

* * * * * * *

[(4)] *(3)* ELECTION TO USE SIMPLIFIED SECTION 904 LIMITATION.—

(A) * * *

* * * * * * *

Subchapter B—Computation of Taxable Income

* * * * * * *

PART III—ITEMS SPECIFICALLY EXCLUDED FROM GROSS INCOME

* * * * * * *

PART III—ITEMS SPECIALLY EXCLUDED FROM GROSS INCOME

* * * * * * *

[SEC. 114. EXTRATERRITORIAL INCOME.

[(a) EXCLUSION.—Gross income does not include extraterritorial income.

[(b) EXCEPTION.—Subsection (a) shall not apply to extraterritorial income which is not qualifying foreign trade income as determined under subpart E of part III of subchapter N.

[(c) DISALLOWANCE OF DEDUCTIONS.—

[(1) IN GENERAL.—Any deduction of a taxpayer allocated under paragraph (2) to extraterritorial income of the taxpayer excluded from gross income under subsection (a) shall not be allowed.

[(2) ALLOCATION.—Any deduction of the taxpayer properly apportioned and allocated to the extraterritorial income derived by the taxpayer from any transaction shall be allocated on a proportionate basis between—

[(A) the extraterritorial income derived from such transaction which is excluded from gross income under subsection (a), and

[(B) the extraterritorial income derived from such transaction which is not so excluded.

[(d) DENIAL OF CREDITS FOR CERTAIN FOREIGN TAXES.—Notwithstanding any other provision of this chapter, no credit shall be allowed under this chapter for any income, war profits, and excess profits taxes paid or accrued to any foreign country or possession of the United States with respect to extraterritorial income which is excluded from gross income under subsection (a).

[(e) EXTRATERRITORIAL INCOME.—For purposes of this section, the term "extraterritorial income" means the gross income of the taxpayer attributable to foreign trading gross receipts (as defined in section 942) of the taxpayer.]

SEC. 121. EXCLUSION OF GAIN FROM SALE OF PRINCIPAL RESIDENCE.

(a) * * *

* * * * * * *

(d) SPECIAL RULES.—

(1) * * *

* * * * * * *

(10) PROPERTY ACQUIRED IN LIKE-KIND EXCHANGE.—If a taxpayer acquired property in an exchange to which section 1031 applied, subsection (a) shall not apply to the sale or exchange of such property if it occurs during the 5-year period beginning with the date of the acquisition of such property.

* * * * * * *

SEC. 139A. INCOME ATTRIBUTABLE TO FILMS USED OUTSIDE THE UNITED STATES.

(a) EXCLUSION.—

(1) IN GENERAL.—There shall be excluded from gross income an amount equal to the applicable percentage of qualified film income.

(2) APPLICABLE PERCENTAGE.—For purposes of paragraph (1), the applicable percentage shall be determined in accordance with the following table:

For taxable years ending in calendar year—	***The applicable percentage is—***
2007	*1*
2008	*2*
2009	*3*
2010	*5*

2011	*8*
2012	*9*
2013 or thereafter	*10.*

(b) QUALIFIED FILM INCOME.—For purposes of this section—

(1) IN GENERAL.—The term "qualified film income" means gross income from a license of a qualified film in the ordinary course of a trade or business for the exploitation or direct use outside the United States less any associated film costs.

(2) EXCEPTIONS.—

(A) CERTAIN USES.—Such term does not include exploitation of characters, soundtracks, designs, scripts, scores, or any other ancillary intangibles associated with the qualified film.

(B) RELATED PERSON LICENSE.—

(i) IN GENERAL.—Such term does not include any amount from the license of a qualified film to a related person.

(ii) EXCEPTION.—Clause (i) shall not apply if such film is held for license by such related person to an unrelated person for the direct use or exploitation by such unrelated person outside the United States.

(iii) RELATED PERSON.—For purposes of this subparagraph, a person shall be related to another person if such persons are treated as a single employer under subsection (a) or (b) of section 52 or subsection (m) or (o) of section 414, except that determinations under subsections (a) and (b) of section 52 shall be made without regard to section 1563(b).

(c) OTHER DEFINITIONS.—For purposes of this section—

(1) QUALIFIED FILM.—The term "qualified film" means property described in section 168(f)(3) the original use of which commences after December 31, 2006, if not less than 50 percent of the total compensation relating to the production of such property is compensation for services performed in the United States by actors, production personnel, directors, and producers. Such term does not include property with respect to which records are required to be maintained under section 2257 of title 18, United States Code.

(2) ASSOCIATED FILM COSTS.—The term "associated film costs" means any expense properly apportioned and allocated to income taken into account under subsection (b)(1), determined as provided under regulations prescribed by the Secretary.

(d) ELECTION.—The taxpayer may elect not to apply this section to a qualified film. Such election shall be made by the due date (including extensions of time) for filing the return for the taxable year in which such film is placed in service, and, once made for such film, such election shall be irrevocable.

(e) DENIAL OF FOREIGN TAX CREDIT.—

(1) IN GENERAL.—No credit shall be allowed under section 901 for any taxes paid or accrued (or treated as paid or accrued) with respect to the excludable portion of any qualified film income. No deduction shall be allowed under this chapter for any tax for which credit is not allowable by reason of the preceding sentence.

(2) EXCLUDABLE PORTION.—For purposes of paragraph (1), the taxes paid or accrued (or treated as paid or accrued) with respect to the excludable portion is the amount which bears the same ratio to the amount of taxes paid or accrued (or treated as paid or accrued) with respect to qualified film income as the amount excluded under subsection (a) for the taxable year bears to the qualified film income for such year.

SEC. 139B. EXCLUSION FROM GROSS INCOME FOR INTEREST ON OVERPAYMENTS OF INCOME TAX BY INDIVIDUALS.

(a) IN GENERAL.—In the case of an individual, gross income shall not include interest paid under section 6611 on any overpayment of tax imposed by this subtitle.

(b) EXCEPTION.—Subsection (a) shall not apply in the case of a failure to claim items resulting in the overpayment on the original return if the Secretary determines that the principal purpose of such failure is to take advantage of subsection (a).

(c) SPECIAL RULE FOR DETERMINING MODIFIED ADJUSTED GROSS INCOME.—For purposes of this title, interest not included in gross income under subsection (a) shall not be treated as interest which is exempt from tax for purposes of sections 32(i)(2)(B) and 6012(d) or any computation in which interest exempt from tax under this title is added to adjusted gross income.

* * * * * * *

PART VI—ITEMIZED DEDUCTIONS FOR INDIVIDUALS AND CORPORATIONS

* * * * * * *

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) * * *

* * * * * * *

(m) CERTAIN EXCESSIVE EMPLOYEE REMUNERATION.—

(1) * * *

* * * * * * *

(4) APPLICABLE EMPLOYEE REMUNERATION.—For purposes of this subsection—

(A) * * *

* * * * * * *

(G) COORDINATION WITH EXCISE TAX ON SPECIFIED STOCK COMPENSATION.—The dollar limitation contained in paragraph (1) with respect to any covered employee shall be reduced (but not below zero) by the amount of any payment (with respect to such employee) of the tax imposed by section 4985 directly or indirectly by the expatriated corporation (as defined in such section) or by any member of the expanded affiliated group (as defined in such section) which includes such corporation.

* * * * * * *

SEC. 163. INTEREST.

(a) * * *

* * * * * * *

(e) ORIGINAL ISSUE DISCOUNT.—

(1) * * *

* * * * * * *

(3) SPECIAL RULE FOR ORIGINAL ISSUE DISCOUNT ON OBLIGATION HELD BY RELATED FOREIGN PERSON.—

(A) * * *

(B) SPECIAL RULE FOR CERTAIN FOREIGN ENTITIES.—

(i) IN GENERAL.—In the case of any debt instrument having original issue discount which is held by a related foreign person which is a foreign personal holding company (as defined in section 552), a controlled foreign corporation (as defined in section 957), or a passive foreign investment company (as defined in section 1297), a deduction shall be allowable to the issuer with respect to such original issue discount for any taxable year before the taxable year in which paid only to the extent such original issue discount is included during such prior taxable year in the gross income of a United States person who owns (within the meaning of section 958(a)) stock in such corporation.

(ii) SECRETARIAL AUTHORITY.—The Secretary may by regulation exempt transactions from the application of clause (i), including any transaction which is entered into by a payor in the ordinary course of a trade or business in which the payor is predominantly engaged.

[(B)] *(C)* RELATED FOREIGN PERSON.—For purposes of subparagraph (A), the term "related foreign person" means any person—

(i) who is not a United States person, and

(ii) who is related (within the meaning of section 267(b)) to the issuer.

[Note: The amendment made by section 1074(c)(34) of H.R. 2896 to section 163(e)(3)(B) (shown below) applies to taxable years of foreign corporations beginning after December 31, 2006, and to taxable years of United States shareholders with or within which such taxable years of foreign corporations end.]

(e) ORIGINAL ISSUE DISCOUNT.—

(1) * * *

* * * * * * *

(3) SPECIAL RULE FOR ORIGINAL ISSUE DISCOUNT ON OBLIGATION HELD BY RELATED FOREIGN PERSON.—

(A) * * *

(B) SPECIAL RULE FOR CERTAIN FOREIGN ENTITIES.—

(i) IN GENERAL.—In the case of any debt instrument having original issue discount which is held by a related foreign person which is a controlled foreign corporation (as defined in section 957) or a passive foreign investment company (as defined in section 1297), a deduction shall be allowable to the issuer with respect to such original issue discount for any taxable year before the taxable year in which paid only to the extent such original issue discount is included during such prior taxable year in the gross income of a United States person who owns (within the meaning of section 958(a)) stock in such corporation.

(ii) SECRETARIAL AUTHORITY.—The Secretary may by regulation exempt transactions from the application of clause (i), including any transaction which is entered into by a payor in the ordinary course of a trade or business in which the payor is predominantly engaged.

* * * * * * *

(j) LIMITATION ON DEDUCTION FOR INTEREST ON CERTAIN INDEBTEDNESS.—

[(1) LIMITATION.—

[(A) IN GENERAL.—If this subsection applies to any corporation for any taxable year, no deduction shall be allowed under this chapter for disqualified interest paid or accrued by such corporation during such taxable year. The amount disallowed under the preceding sentence shall not exceed the corporation's excess interest expense for the taxable year.

[(B) DISALLOWED AMOUNT CARRIED TO SUCCEEDING TAXABLE YEAR.—Any amount disallowed under subparagraph (A) for any taxable year shall be treated as disqualified interest paid or accrued in the succeeding taxable year (and clause (ii) of paragraph (2)(A) shall not apply for purposes of applying this subsection to the amount so treated).

[(2) CORPORATIONS TO WHICH SUBSECTION APPLIES.—

[(A) IN GENERAL.—This subsection shall apply to any corporation for any taxable year if—

[(i) such corporation has excess interest expense for such taxable year, and

[(ii) the ratio of debt to equity of such corporation as of the close of such taxable year (or on any other day during the taxable year as the Secretary may by regulations prescribe) exceeds 1.5 to 1.

[(B) EXCESS INTEREST EXPENSE.—

[(i) IN GENERAL.—For purposes of this subsection, the term "excess interest expense" means the excess (if any) of—

[(I) the corporation's net interest expense, over

[(II) the sum of 50 percent of the adjusted taxable income of the corporation plus any excess limitation carryforward under clause (ii).

[(ii) EXCESS LIMITATION CARRYFORWARD.—If a corporation has an excess limitation for any taxable year, the amount of such excess limitation shall be an excess limitation carryforward to the 1st succeeding taxable year and to the 2nd and 3rd succeeding taxable years to the extent not previously taken into account under this clause. The amount of such a carryforward taken into account for any such succeeding taxable year shall not exceed the excess interest expense for such succeeding taxable year (determined without regard to the carryforward from the taxable year of such excess limitation).

[(iii) EXCESS LIMITATION.—For purposes of clause (ii), the term "excess limitation" means the excess (if any) of—

⟦(I) 50 percent of the adjusted taxable income of the corporation, over

⟦(II) the corporation's net interest expense.

⟦(C) RATIO OF DEBT TO EQUITY.—For purposes of this paragraph, the term "ratio of debt to equity" means the ratio which the total indebtedness of the corporation bears to the sum of its money and all other assets reduced (but not below zero) by such total indebtedness. For purposes of the preceding sentence—

⟦(i) the amount taken into account with respect to any asset shall be the adjusted basis thereof for purposes of determining gain,

⟦(ii) the amount taken into account with respect to any indebtedness with original issue discount shall be its issue price plus the portion of the original issue discount previously accrued as determined under the rules of section 1272 (determined without regard to subsection (a)(7) or (b)(4) thereof), and

⟦(iii) there shall be such other adjustments as the Secretary may by regulations prescribe.⟧

(1) LIMITATION.—

(A) IN GENERAL.—In the case of a corporation, no deduction shall be allowed under this chapter for disqualified interest paid or accrued during the taxable year.

(B) MAXIMUM DISALLOWANCE.—The amount disallowed under subparagraph (A) shall not exceed the sum of—

(i) the corporation's excess interest expense for the taxable year, and

(ii) the corporation's excess related party interest expense for such year.

In no event shall the disallowance under subparagraph (A) reduce the deduction for interest below the sum of the amount of interest includible in the gross income of the taxpayer for such taxable year and an amount equal to 25 percent of adjusted taxable income (35 percent in the case of the first taxable year beginning after December 31, 2003).

(C) DISALLOWED AMOUNT CARRIED TO SUCCEEDING TAXABLE YEAR.—

(i) IN GENERAL.—Any amount disallowed under subparagraph (A) for any taxable year shall be treated as paid or accrued in the succeeding taxable year and in the 2nd through 10th succeeding taxable years to the extent not previously taken into account under this subparagraph.

(ii) LIMITATION ON AMOUNT CARRIED TO YEAR.—A carryforward amount may not be taken into account for any such succeeding taxable year to the extent that such amount, when added to amounts carried to such succeeding taxable year from taxable years preceding the taxable year from which the amount is being carried forward, would result in (or increase) a disallowance under subparagraph (A).

(iii) CARRYOVER APPLIED SEPARATELY TO CATEGORIES OF DISQUALIFIED INTEREST.—Clauses (i) and (ii) shall be applied separately to disqualified interest described

in paragraph (3)(A) and to disqualified interest described in paragraph (3)(B). For purposes of this subparagraph, any amount disallowed under subparagraph (A) for any taxable year shall be treated as disqualified interest described in paragraph (3)(A) to the extent thereof and then as disqualified interest described in paragraph (3)(B).

(2) EXCESS INTEREST EXPENSE; EXCESS RELATED PARTY INTEREST EXPENSE.—For purposes of this subsection—

(A) EXCESS INTEREST EXPENSE.—The term "excess interest expense" means the excess (if any) of—

(i) the corporation's net interest expense, over

(ii) 50 percent of the adjusted taxable income of the corporation.

(B) EXCESS RELATED PARTY INTEREST EXPENSE.—The term "excess related party interest expense" means the excess (if any) of—

(i) the lesser of—

(I) the amount of disqualified interest described in paragraph (3)(A), or

(II) the corporation's net interest expense, over

(ii) 25 percent (35 percent in the case of the first taxable year beginning after December 31, 2003) of the adjusted taxable income of the corporation.

(3) ALTERNATIVE MAXIMUM DISALLOWANCE.—

(A) IN GENERAL.—In the case of a corporation with respect to which an election is in effect under subparagraph (B), the amount disallowed under paragraph (1)(A) shall not exceed the excess (if any) of—

(i) the corporation's net interest expense, over

(ii) 30 percent of the adjusted taxable income of the corporation.

(B) ELECTION.—A corporation may make a one-time irrevocable election to have the alternative maximum disallowance described in subparagraph (A) apply for purposes of this subsection in lieu of paragraph (1)(B). An election under this subparagraph shall not apply with respect to any taxable year beginning before January 1, 2005.

(C) LIMITATION.—Subparagraph (B) shall not apply with respect to any corporation which is—

(i) a surrogate foreign corporation (as defined in section 7874(a)(2)(B)),

(ii) a corporation which would be a surrogate foreign corporation (as so defined) if "December 31, 1996" were substituted for "March 4, 2003" in section 7874(a), or

(iii) a corporation which is an expatriated entity (as defined in section 7874(a)) with respect to a corporation described in clause (i) or (ii).

【(3)】 *(4)* DISQUALIFIED INTEREST.—For purposes of this subsection, the term "disqualified interest" means—

(A) any interest paid or accrued by the taxpayer (directly or indirectly) to a related person if no tax is imposed by this subtitle with respect to such interest, *and*

(B) any interest paid or accrued by the taxpayer with respect to any indebtedness to a person who is not a related person if—

(i) * * *

(ii) no gross basis tax is imposed by this subtitle with respect to such interest【, and】.

【(C) any interest paid or accrued (directly or indirectly) by a taxable REIT subsidiary (as defined in section 856(l)) of a real estate investment trust to such trust.】

【(4)】 *(5)* RELATED PERSON.—For purposes of this subsection—

(A) * * *

(B) SPECIAL RULE FOR CERTAIN PARTNERSHIPS.—

(i) * * *

(ii) SPECIAL RULE WHERE TREATY REDUCTION.—If any treaty between the United States and any foreign country reduces the rate of tax imposed by this subtitle on a partner's share of any interest paid or accrued to a partnership, such partner's interests in such partnership shall, for purposes of clause (i), be treated as held in part by a tax-exempt person and in part by a taxable person under rules similar to the rules of paragraph 【(5)(B)】 *(6)(B)*.

* * * * * * *

【(5)】 *(6)* SPECIAL RULES FOR DETERMINING WHETHER INTEREST IS SUBJECT TO TAX.—

(A) * * *

* * * * * * *

【(6)】 *(7)* OTHER DEFINITIONS AND SPECIAL RULES.—For purposes of this subsection—

(A) * * *

* * * * * * *

【(7)】 *(8)* COORDINATION WITH PASSIVE LOSS RULES, ETC.—This subsection shall be applied before sections 465 and 469.

【(8)】 *(9)* REGULATIONS.—The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this subsection, including—

(A) * * *

* * * * * * *

(m) INTEREST ON UNPAID TAXES ATTRIBUTABLE TO NONDISCLOSED REPORTABLE TRANSACTIONS.—No deduction shall be allowed under this chapter for any interest paid or accrued under section 6601 on any underpayment of tax which is attributable to the portion of any reportable transaction understatement (as defined in section 6662A(b)) with respect to which the requirement of section 6664(d)(2)(A) is not met.

【(m)】 *(n)* CROSS REFERENCES.—

(1) * * *

* * * * * * *

SEC. 168. ACCELERATED COST RECOVERY SYSTEM.

(a) * * *

(b) APPLICABLE DEPRECIATION METHOD.—For purposes of this section—

(1) * * *

(2) 150 percent declining balance method in certain cases Paragraph (1) shall be applied by substituting “150 percent” for “200 percent” in the case of—

(A) any 15-year or 20-year property *not referred to in paragraph (3)*,

* * * * * * *

(3) PROPERTY TO WHICH STRAIGHT LINE METHOD APPLIES.—The applicable depreciation method shall be the straight line method in the case of the following property:

(A) * * *

* * * * * * *

(G) Qualified leasehold improvement property described in subsection (e)(6).

(H) Qualified restaurant property described in subsection (e)(7).

* * * * * * *

(e) CLASSIFICATION OF PROPERTY.—For purposes of this section—

(1) * * *

* * * * * * *

(3) CLASSIFICATION OF CERTAIN PROPERTY.—

(A) * * *

* * * * * * *

(E) 15-YEAR PROPERTY.—The term “15-year property” includes—

(i) * * *

(ii) any telephone distribution plant and comparable equipment used for 2-way exchange of voice and data communications, **[**and**]**

(iii) any section 1250 property which is a retail motor fuels outlet (whether or not food or other convenience items are sold at the outlet)**[**.**]***,*

(iv) any qualified leasehold improvement property placed in service before January 1, 2006, and

(v) any qualified restaurant property placed in service before January 1, 2006.

* * * * * * *

(6) QUALIFIED LEASEHOLD IMPROVEMENT PROPERTY.—The term “qualified leasehold improvement property” has the meaning given such term in section 168(k)(3) except that the following special rules shall apply:

(A) IMPROVEMENTS MADE BY LESSOR.—In the case of an improvement made by the person who was the lessor of such improvement when such improvement was placed in service, such improvement shall be qualified leasehold improvement property (if at all) only so long as such improvement is held by such person.

(B) EXCEPTION FOR CHANGES IN FORM OF BUSINESS.—Property shall not cease to be qualified leasehold improvement property under subparagraph (A) by reason of—

(i) death,

(ii) a transaction to which section 381(a) applies,

(iii) a mere change in the form of conducting the trade or business so long as the property is retained in such trade or business as qualified leasehold improvement property and the taxpayer retains a substantial interest in such trade or business,

(iv) the acquisition of such property in an exchange described in section 1031, 1033, or 1038 to the extent that the basis of such property includes an amount representing the adjusted basis of other property owned by the taxpayer or a related person, or

(v) the acquisition of such property by the taxpayer in a transaction described in section 332, 351, 361, 721, or 731 (or the acquisition of such property by the taxpayer from the transferee or acquiring corporation in a transaction described in such section), to the extent that the basis of the property in the hands of the taxpayer is determined by reference to its basis in the hands of the transferor or distributor.

(7) QUALIFIED RESTAURANT PROPERTY.—The term "qualified restaurant property" means any section 1250 property which is an improvement to a building if—

(A) such improvement is placed in service more than 3 years after the date such building was first placed in service, and

(B) more than 50 percent of the building's square footage is devoted to preparation of, and seating for on-premises consumption of, prepared meals.

* * * * * * *

(g) ALTERNATIVE DEPRECIATION SYSTEM FOR CERTAIN PROPERTY.—

(1) * * *

* * * * * * *

(3) SPECIAL RULES FOR DETERMINING CLASS LIFE.—

(A) * * *

(B) SPECIAL RULE FOR CERTAIN PROPERTY ASSIGNED TO CLASSES.—For purposes of paragraph (2), in the case of property described in any of the following subparagraphs of subsection (e)(3), the class life shall be determined as follows:

If property is described in subparagraph:	**The class life is:**
(A)(iii)	4
(B)(ii)	5
(B)(iii)	9.5
(C)(i)	10
(D)(i)	15
(D)(ii)	20
(E)(i)	24
(E)(ii)	24
(E)(iii)	20
(E)(iv)	*39*
(E)(v)	*39*

* * * * * * *

SEC. 170. CHARITABLE, ETC., CONTRIBUTIONS AND GIFTS.

(a) * * *

* * * * * * *

(f) DISALLOWANCE OF DEDUCTION IN CERTAIN CASES AND SPECIAL RULES.—

(1) * * *

* * * * * * *

(10) SPLIT-DOLLAR LIFE INSURANCE, ANNUITY, AND ENDOWMENT CONTRACTS.—

(A) IN GENERAL.—Nothing in this section or in section 545(b)(2), [556(b)(2),] 642(c), 2055, 2106(a)(2), or 2522 shall be construed to allow a deduction, and no deduction shall be allowed, for any transfer to or for the use of an organization described in subsection (c) if in connection with such transfer—

(i) * * *

* * * * * * *

SEC. 171. AMORTIZABLE BOND PREMIUM.

(a) * * *

* * * * * * *

(c) ELECTION AS TO TAXABLE BONDS.—

(1) * * *

(2) MANNER AND EFFECT OF ELECTION.—The election authorized under this subsection shall be made in accordance with such regulations as the Secretary shall prescribe. If such election is made with respect to any bond (described in paragraph (1)) of the taxpayer, it shall also apply to all such bonds held by the taxpayer at the beginning of the first taxable year to which the election applies and to all such bonds thereafter acquired by him and shall be binding for all subsequent taxable years with respect to all such bonds of the taxpayer, unless, on application by the taxpayer, the Secretary permits him, subject to such conditions as the Secretary deems necessary, to revoke such election. In the case of bonds held by a common trust fund, as defined in section 584(a)[, or by a foreign personal holding company, as defined in section 552], the election authorized under this subsection shall be exercisable with respect to such bonds only by the common trust fund [or foreign personal holding company]. In case of bonds held by an estate or trust, the election authorized under this subsection shall be exercisable with respect to such bonds only by the fiduciary.

* * * * * * *

SEC. 179. ELECTION TO EXPENSE CERTAIN DEPRECIABLE BUSINESS ASSETS.

(a) * * *

(b) LIMITATIONS.—

(1) DOLLAR LIMITATION.—The aggregate cost which may be taken into account under subsection (a) for any taxable year shall not exceed $25,000 ($100,000 in the case of taxable years beginning after 2002 and before [2006] *2008*).

(2) REDUCTION IN LIMITATION.—The limitation under paragraph (1) for any taxable year shall be reduced (but not below

zero) by the amount by which the cost of section 179 property placed in service during such taxable year exceeds $200,000 ($400,000 in the case of taxable years beginning after 2002 and before ⟦2006⟧ *2008*).

* * * * * * *

(5) INFLATION ADJUSTMENTS.—

(A) IN GENERAL.—In the case of any taxable year beginning in a calendar year after 2003 and before ⟦2006⟧ *2008*, the $100,000 and $400,000 amounts in paragraphs (1) and (2) shall each be increased by an amount equal to—

(i) * * *

* * * * * * *

(c) ELECTION.—

(1) * * *

(2) ELECTION IRREVOCABLE.—Any election made under this section, and any specification contained in any such election, may not be revoked except with the consent of the Secretary. Any such election or specification with respect to any taxable year beginning after 2002 and before ⟦2006⟧ *2008* may be revoked by the taxpayer with respect to any property, and such revocation, once made, shall be irrevocable.

(d) DEFINITIONS AND SPECIAL RULES.—

(1) SECTION 179 PROPERTY.—For purposes of this section, the term "section 179 property" means property—

(A) which is—

(i) * * *

(ii) computer software (as defined in section 197(e)(3)(B)) which is described in section 197(e)(3)(A)(i), to which section 167 applies, and which is placed in service in a taxable year beginning after 2002 and before ⟦2006⟧ *2008*,

* * * * * * *

PART VIII—SPECIAL DEDUCTION FOR CORPORATIONS

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SEC. 245. DIVIDENDS RECEIVED FROM CERTAIN FOREIGN CORPORATIONS

(a) DIVIDENDS FROM 10-PERCENT OWNED FOREIGN CORPORATIONS.—

(1) * * *

(2) QUALIFIED 10-PERCENT OWNED FOREIGN CORPORATION.—For purposes of this subsection, the term "qualified 10-percent owned foreign corporation" means any foreign corporation (other than a ⟦foreign personal holding company or⟧ passive foreign investment company) if at least 10 percent of the stock of such corporation (by vote and value) is owned by the taxpayer.

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PART IX—ITEMS NOT DEDUCTIBLE

* * * * * * *

SEC. 267. LOSSES, EXPENSES, AND INTEREST WITH RESPECT TO TRANSACTIONS BETWEEN RELATED TAXPAYERS.

(a) IN GENERAL.—

(1) * * *

* * * * * * *

(3) PAYMENTS TO FOREIGN PERSONS.—[The Secretary]

(A) IN GENERAL.—The Secretary shall by regulations apply the matching principle of paragraph (2) in cases in which the person to whom the payment is to be made is not a United States person.

(B) SPECIAL RULE FOR CERTAIN FOREIGN ENTITIES.—

(i) IN GENERAL.—Notwithstanding subparagraph (A), in the case of any amount payable to a foreign personal holding company (as defined in section 552), a controlled foreign corporation (as defined in section 957), or a passive foreign investment company (as defined in section 1297), a deduction shall be allowable to the payor with respect to such amount for any taxable year before the taxable year in which paid only to the extent such amount is included during such prior taxable year in the gross income of a United States person who owns (within the meaning of section 958(a)) stock in such corporation.

(ii) SECRETARIAL AUTHORITY.—The Secretary may by regulation exempt transactions from the application of clause (i), including any transaction which is entered into by a payor in the ordinary course of a trade or business in which the payor is predominantly engaged and in which the payment of the accrued amounts occurs within 8½ months after accrual or within such other period as the Secretary may prescribe.

[Note: The amendment made by section 1074(c)(34) of H.R. 2896 to section 267(a)(3)(B)(i) (shown below) applies to taxable years of foreign corporations beginning after December 31, 2006, and to taxable years of United States shareholders with or within which such taxable years of foreign corporations end.]

SEC. 267. LOSSES, EXPENSES, AND INTEREST WITH RESPECT TO TRANSACTIONS BETWEEN RELATED TAXPAYERS.

(a) IN GENERAL.—

(1) * * *

* * * * * * *

(3) PAYMENTS TO FOREIGN PERSONS.—

(A) * * *

(B) SPECIAL RULE FOR CERTAIN FOREIGN ENTITIES.—

(i) IN GENERAL.—Notwithstanding subparagraph (A), in the case of any amount payable to a controlled foreign corporation (as defined in section 957) or a passive foreign investment company (as defined in section 1297), a deduction shall be allowable to the payor with respect to such amount for any taxable year before the taxable year in which paid only to the extent such amount is included during such prior taxable year in the gross income of a United States person who owns

(within the meaning of section 958(a)) stock in such corporation.

* * * * * * *

SEC. 275. CERTAIN TAXES.

(a) GENERAL RULE.—No deduction shall be allowed for the following taxes:

(1) * * *

* * * * * * *

(6) TAXES IMPOSED BY CHAPTERS 41, 42, 43, 44, *45,* 46, AND 54.—Paragraph (1) shall not apply to any taxes to the extent such taxes are allowable as a deduction under section 164(f). Paragraph (1) shall not apply to the tax imposed by section 59A.

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Subchapter C—Corporate Distributions and Adjustments

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PART I—DISTRIBUTIONS BY CORPORATIONS

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Subpart B—Effects on Corporation

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SEC. 312. EFFECT ON EARNINGS AND PROFITS.

(a) * * *

* * * * * * *

⟦(j) EARNINGS AND PROFITS OF FOREIGN INVESTMENT COMPANIES.—

⟦(1) ALLOCATION WITHIN AFFILIATED GROUP.—In the case of a sale or exchange of stock in a foreign investment company (as defined in section 1246(b)) by a United States person (as defined in section 7701(a)(30)), if such company is a member of an affiliated group, then the accumulated earnings and profits of all members of such affiliated group shall be allocated, under regulations prescribed by the Secretary, in such manner as is proper to carry out the purposes of section 1246.

⟦(2) AFFILIATED GROUP DEFINED.—For purposes of paragraph (1) of this subsection, the term "affiliated group" has the meaning assigned to such term by section 1504(a); except that (A) "more than 50 percent" shall be substituted for "80 percent or more", and (B) all corporations shall be treated as includible corporations (without regard to the provisions of section 1504(b)).⟧

* * * * * * *

(m) NO ADJUSTMENT FOR INTEREST PAID ON CERTAIN REGISTRATION-REQUIRED OBLIGATIONS NOT IN REGISTERED FORM.—The earnings and profits of any corporation shall not be decreased by any interest with respect to which a deduction is not or would not be allowable by reason of section 163(f), unless at the time of issuance the issuer is a foreign corporation that is not a controlled foreign corporation (within the meaning of section 957**[**, a foreign investment company (within the meaning of section 1246(b)), or a foreign personal holding company (within the meaning of section 552)**]** and the issuance did not have as a purpose the avoidance of section 163(f) or this subsection.

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PART II—CORPORATE LIQUIDATIONS

* * * * * * *

Subpart B—Effects on Corporation

* * * * * * *

SEC. 338. CERTAIN STOCK PURCHASES TREATED AS ASSET ACQUISITIONS.

(a) * * *

* * * * * * *

(h) DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

(1) * * *

* * * * * * *

(13) TAX ON DEEMED SALE NOT TAKEN INTO ACCOUNT FOR ESTIMATED TAX PURPOSES.—For purposes of section 6655, tax attributable to the sale described in subsection (a)(1) shall not be taken into account. *The preceding sentence shall not apply with respect to a qualified stock purchase for which an election is made under paragraph (10).*

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PART III—CORPORATE ORGANIZATIONS AND REORGANIZATIONS

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Subpart C—Effects on Corporations

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SEC. 362. BASIS TO CORPORATIONS.

(a) * * *

* * * * * * *

(e) LIMITATION ON TRANSFER OF BUILT-IN LOSSES ON REMIC RESIDUALS IN SECTION 351 TRANSACTIONS.—If—

(1) a residual interest (as defined in section 860G(a)(2)) in a REMIC is transferred in any transaction which is described in subsection (a), and

(2) the transferee's adjusted basis in such residual interest would (but for this paragraph) exceed its fair market value immediately after such transaction,

then, notwithstanding subsection (a), the transferee's adjusted basis in such residual interest shall not exceed its fair market value *(whether or not greater than zero) immediately after such transaction.*

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Subpart D—Special Rule; Definitions

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SEC. 367. FOREIGN CORPORATIONS

(a) * * *

* * * * * * *

(d) SPECIAL RULES RELATING TO TRANSFERS OF INTANGIBLES.—

(1) * * *

(2) TRANSFER OF INTANGIBLES TREATED AS TRANSFER PURSUANT TO SALE OF CONTINGENT PAYMENTS.—

(A) * * *

* * * * * * *

(C) AMOUNTS RECEIVED TREATED AS ORDINARY INCOME.—For purposes of this chapter, any amount included in gross income by reason of this subsection shall be treated as ordinary income. *For purposes of applying section 904(d), any such amount shall be treated in the same manner as if such amount were a royalty.*

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PART V—CARRYOVERS

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SEC. 382. LIMITATION ON NET OPERATING LOSS CARRYFORWARDS AND CERTAIN BUILT-IN LOSSES FOLLOWING OWNERSHIP CHANGE.

(a) * * *

* * * * * * *

(l) CERTAIN ADDITIONAL OPERATING RULES.—For purposes of this section—

(1) * * *

* * * * * * *

(4) REDUCTION IN VALUE WHERE SUBSTANTIAL NONBUSINESS ASSETS.—

(A) * * *

(B) CORPORATION HAVING SUBSTANTIAL NONBUSINESS ASSETS.—For purposes of subparagraph (A)—

(i) * * *

(ii) EXCEPTION FOR CERTAIN INVESTMENT ENTITIES.—A regulated investment company to which part I of subchapter M applies, a real estate investment trust to which part II of subchapter M applies, ⟦a REMIC to which part IV of subchapter M applies, or a FASIT to which part V of subchapter M applies,⟧ *or a REMIC to which part IV of subchapter M applies,* shall not be treated as a new loss corporation having substantial nonbusiness assets.

* * * * * * *

Subchapter D—Deffered Compensation, Etc.

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PART I—PENSION, PROFIT-SHARING, STOCK BONUS PLANS, ETC.

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Subpart A—General Rule

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SEC. 409A. INCLUSION IN GROSS INCOME OF DEFERRED COMPENSATION UNDER NONQUALIFIED DEFERRED COMPENSATION PLANS.

(a) RULES RELATING TO CONSTRUCTIVE RECEIPT.—

(1) IN GENERAL.—

(A) GROSS INCOME INCLUSION.—In the case of a nonqualified deferred compensation plan, all compensation deferred under the plan for all taxable years (to the extent not subject to a substantial risk of forfeiture and not previously included in gross income) shall be includible in gross income for the taxable year unless at all times during the taxable year the plan meets the requirements of paragraphs (2), (3), and (4) and is operated in accordance with such requirements.

(B) INTEREST ON TAX LIABILITY PAYABLE WITH RESPECT TO PREVIOUSLY DEFERRED COMPENSATION.—

(i) IN GENERAL.—If compensation is required to be included in gross income under subparagraph (A) for a taxable year, the tax imposed by this chapter for such taxable year shall be increased by the amount of interest determined under clause (ii).

(ii) INTEREST.—For purposes of clause (i), the interest determined under this clause for any taxable year is the amount of interest at the underpayment rate plus 1 percentage point on the underpayments that would have occurred had the deferred compensation been includible in gross income for the taxable year in which first deferred or, if later, the first taxable year in which such deferred compensation is not subject to a substantial risk of forfeiture.

(2) DISTRIBUTIONS.—

(A) IN GENERAL.—The requirements of this paragraph are met if the plan provides that compensation deferred under the plan may not be distributed earlier than—

(i) separation from service as determined by the Secretary (except as provided in subparagraph (B)(i)),

(ii) disability (as defined by section 223(d) of the Social Security Act),

(iii) death,

(iv) a specified time (or pursuant to a fixed schedule) specified under the plan at the date of the deferral of such compensation,

(v) to the extent provided by the Secretary, a change in the ownership or effective control of the corporation, or in the ownership of a substantial portion of the assets of the corporation, or

(vi) the occurrence of an unforeseeable emergency.

(B) SPECIAL RULES.—

(i) SPECIFIED EMPLOYEES.—In the case of specified employees, the requirement of subparagraph (A)(i) is met only if distributions may not be made earlier than 6 months after the date of separation from service. For purposes of the preceding sentence, a specified employee is a key employee (as defined in section 416(i)) of a corporation the stock in which is publicly traded on an established securities market or otherwise.

(ii) UNFORESEEABLE EMERGENCY.—For purposes of subparagraph (A)(vi)—

(I) IN GENERAL.—The term "unforeseeable emergency" means a severe financial hardship to the participant resulting from a sudden and unexpected illness or accident of the participant, the participant's spouse, or a dependent (as defined in section 152(a)) of the participant, loss of the participant's property due to casualty, or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant.

(II) LIMITATION ON DISTRIBUTIONS.—The requirement of subparagraph (A)(vi) is met only if, as determined under regulations of the Secretary, the amounts distributed with respect to an emergency do not exceed the amounts necessary to satisfy such emergency plus amounts necessary to pay taxes reasonably anticipated as a result of the distribution, after taking into account the extent to which such hardship is or may be relieved through reimbursement or compensation by insurance or otherwise or by liquidation of the participant's assets (to the extent the liquidation of such assets would not itself cause severe financial hardship).

(3) ACCELERATION OF BENEFITS.—The requirements of this paragraph are met if the plan does not permit the acceleration of the time or schedule of any payment under the plan, except as provided in regulations by the Secretary.

(4) ELECTIONS.—

(A) IN GENERAL.—The requirements of this paragraph are met if the requirements of subparagraphs (B) and (C) are met.

(B) INITIAL DEFERRAL DECISION.—The requirements of this subparagraph are met if the plan provides that compensation for services performed during a taxable year may be deferred at the participant's election only if the election to defer such compensation is made during the preceding

taxable year or at such other time as provided in regulations. In the case of the first year in which a participant becomes eligible to participate in the plan, such election may be made with respect to services to be performed subsequent to the election within 30 days after the date the participant becomes eligible to participate in such plan.

(C) CHANGES IN TIME AND FORM OF DISTRIBUTION.—The requirements of this subparagraph are met if, in the case of a plan which permits under a subsequent election a delay in a payment or a change in the form of payment—

(i) the plan requires that such election may not take effect until at least 12 months after the date on which the election is made,

(ii) in the case an election related to a payment not described in clause (ii), (iii), or (vi) of paragraph (2)(A), the plan requires that the first payment with respect to which such election is made be deferred for a period of not less than 5 years from the date such payment would otherwise have been made, and

(iii) the plan requires that any election related to a payment described in paragraph (2)(A)(iv) may not be made less than 12 months prior to the date of the first scheduled payment under such paragraph.

(b) RULES RELATING TO FUNDING.—

(1) OFFSHORE PROPERTY IN A TRUST.—In the case of assets held in a trust or set aside (directly or indirectly) in another arrangement, as determined by the Secretary, for purposes of paying deferred compensation under a nonqualified deferred compensation plan, for purposes of section 83 such assets shall be treated as property transferred in connection with the performance of services whether or not such assets are available to satisfy claims of general creditors—

(A) at the time set aside if such assets are located outside of the United States, or

(B) at the time transferred if such assets are subsequently transferred outside of the United States.

(2) EMPLOYER'S FINANCIAL HEALTH.—In the case of a nonqualified deferred compensation plan, there is a transfer of property within the meaning of section 83 as of the earlier of—

(A) the date on which the plan first provides that assets will become restricted to the provision of benefits under the plan in connection with a change in the employer's financial health, or

(B) the date on which assets are so restricted.

(3) INCOME INCLUSION FOR OFFSHORE TRUSTS AND EMPLOYER'S FINANCIAL HEALTH.—For each taxable year that assets treated as transferred under this subsection remain set aside in a trust or other arrangement subject to paragraph (1) or (2), any increase in value in, or earnings with respect to, such assets shall be treated as an additional transfer of property under this subsection (to the extent not previously included in income).

(4) INTEREST ON TAX LIABILITY PAYABLE WITH RESPECT TO TRANSFERRED PROPERTY.—

(A) IN GENERAL.—If amounts are required to be included in gross income by reason of paragraph (1) or (2) for a tax-

able year, the tax imposed by this chapter for such taxable year shall be increased by the amount of interest determined under subparagraph (B).

(B) INTEREST.—The interest determined under this subparagraph for any taxable year is the amount of interest at the underpayment rate plus 1 percentage point on the underpayments that would have occurred had the amounts so required to be included in gross income by paragraph (1) or (2) been includible in gross income for the taxable year in which such assets were first set aside (directly or indirectly) in a trust (or other arrangement determined by the Secretary) for purposes of the nonqualified deferred compensation plan.

(c) NO INFERENCE ON EARLIER INCOME INCLUSION OR REQUIREMENT OF LATER INCLUSION.—Nothing in this section shall be construed to prevent the inclusion of amounts in gross income under any other provision of this chapter or any other rule of law earlier than the time provided in this section. Any amount included in gross income under this section shall not be required to be included in gross income under any other provision of this chapter or any other rule of law later than the time provided in this section.

(d) OTHER DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

(1) NONQUALIFIED DEFERRED COMPENSATION PLAN.—The term "nonqualified deferred compensation plan" means any plan that provides for the deferral of compensation, other than—

(A) a qualified employer plan, and

(B) any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan.

(2) QUALIFIED EMPLOYER PLAN.—The term "qualified employer plan" means—

(A) any plan, contract, pension, account, or trust described in subparagraph (A) or (B) of section 219(g)(5), and

(B) any eligible deferred compensation plan (within the meaning of section 457(b)) of an employer described in section 457(e)(1)(A).

(3) PLAN INCLUDES ARRANGEMENTS, ETC.—The term "plan" includes any agreement or arrangement, including an agreement or arrangement that includes one person.

(4) SUBSTANTIAL RISK OF FORFEITURE.—The rights of a person to compensation are subject to a substantial risk of forfeiture if such person's rights to such compensation are conditioned upon the future performance of substantial services by any individual.

(5) TREATMENT OF EARNINGS.—References to deferred compensation shall be treated as including references to income (whether actual or notional) attributable to such compensation or such income.

(e) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including regulations—

(1) providing for the determination of amounts of deferral in the case of a nonqualified deferred compensation plan which is a defined benefit plan,

(2) relating to changes in the ownership and control of a corporation or assets of a corporation for purposes of subsection (a)(2)(A)(v),

(3) exempting arrangements from the application of subsection (b) if such arrangements will not result in an improper deferral of United States tax and will not result in assets being effectively beyond the reach of creditors,

(4) defining financial health for purposes of subsection (b)(2), and

(5) disregarding a substantial risk of forfeiture in cases where necessary to carry out the purposes of this section.

* * * * * * *

Subpart B—Special Rules

* * * * * * *

SEC. 414. DEFINITIONS AND SPECIAL RULES.

(a) * * *

(b) EMPLOYEES OF CONTROLLED GROUP OF CORPORATIONS.—For purposes of sections 401, 408(k), 408(p), *409A,* 410, 411, 415, and 416, all employees of all corporations which are members of a controlled group of corporations (within the meaning of section 1563(a), determined without regard to section 1563(a)(4) and (e)(3)(C)) shall be treated as employed by a single employer. With respect to a plan adopted by more than one such corporation, the applicable limitations provided by section 404(a) shall be determined as if all such employers were a single employer, and allocated to each employer in accordance with regulations prescribed by the Secretary.

(c) EMPLOYEES OF PARTNERSHIPS, PROPRIETORSHIPS, ETC., WHICH ARE UNDER COMMON CONTROL.—For purposes of sections 401, 408(k), 408(p), *409A,* 410, 411, 415, and 416, under regulations prescribed by the Secretary, all employees of trades or businesses (whether or not incorporated) which are under common control shall be treated as employed by a single employer. The regulations prescribed under this subsection shall be based on principles similar to the principles which apply in the case of subsection (b).

* * * * * * *

Subpart E—Transfer of Excess Pension Assets to Retiree Health Accounts

* * * * * * *

SEC. 420. TRANSFERS OF EXCESS PENSION ASSETS TO RETIREE HEALTH ACCOUNTS.

(a) * * *

(b) QUALIFIED TRANSFER.—For purposes of this section—

(1) * * *

* * * * * * *

(5) EXPIRATION.—No transfer made after December 31, ⟦2005⟧ *2013*, shall be treated as a qualified transfer.

* * * * * * *

PART II—CERTAIN STOCK OPTIONS

* * * * * * *

SEC. 421. GENERAL RULES.

(a) * * *

(b) EFFECT OF DISQUALIFYING DISPOSITION.—If the transfer of a share of stock to an individual pursuant to his exercise of an option would otherwise meet the requirements of section 422(a) or 423(a) except that there is a failure to meet any of the holding period requirements of section 422(a)(1) or 423(a)(1), then any increase in the income of such individual or deduction from the income of his employer corporation for the taxable year in which such exercise occurred attributable to such disposition, shall be treated as an increase in income or a deduction from income in the taxable year of such individual or of such employer corporation in which such disposition occurred. *No amount shall be required to be deducted and withheld under chapter 24 with respect to any increase in income attributable to a disposition described in the preceding sentence.*

* * * * * * *

SEC. 423. EMPLOYEE STOCK PURCHASE PLANS.

(a) * * *

* * * * * * *

(c) SPECIAL RULE WHERE OPTION PRICE IS BETWEEN 85 PERCENT AND 100 PERCENT OF VALUE OF STOCK.—If the option price of a share of stock acquired by an individual pursuant to a transfer to which subsection (a) applies was less than 100 percent of the fair market value of such share at the time such option was granted, then, in the event of any disposition of such share by him which meets the holding period requirements of subsection (a), or in the event of his death (whenever occurring) while owning such share, there shall be included as compensation (and not as gain upon the sale or exchange of a capital asset) in his gross income, for the taxable year in which falls the date of such disposition or for the taxable year closing with his death, whichever applies, an amount equal to the lesser of—

(1) * * *

* * * * * * *

No amount shall be required to be deducted and withheld under chapter 24 with respect to any amount treated as compensation under this subsection.

* * * * * * *

Subchapter E—Accounting Period and Methods of Accounting

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PART I—ACCOUNTING PERIODS

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SEC. 443. RETURNS FOR A PERIOD OF LESS THAN 12 MONTHS.

(a) * * *

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(e) CROSS REFERENCES.—

For inapplicability of subsection (b) in computing—

(1) * * *

* * * * * * *

[(3) Undistributed foreign personal holding company income, see section 557.]

[(4)] *(3)* The taxable income of a regulated investment company, see section 852(b)(2)(E).

[(5)] *(4)* The taxable income of a real estate investment trust, see section 857(b)(2)(C).

* * * * * * *

PART II—METHODS OF ACCOUNTING IN GENERAL

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Subpart B—Taxable Year for Which Items of Gross Income Included

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SEC. 451. GENERAL RULE FOR TAXABLE YEAR OF INCLUSION.

(a) * * *

* * * * * * *

(e) SPECIAL RULE FOR PROCEEDS FROM LIVESTOCK SOLD ON ACCOUNT OF DROUGHT, FLOOD, OR OTHER WEATHER-RELATED CONDITIONS.—

(1) * * *

* * * * * * *

(3) SPECIAL ELECTION RULES.—If section 1033(e)(2) applies to a sale or exchange of livestock described in paragraph (1), the election under paragraph (1) shall be deemed valid if made during the replacement period described in such section.

* * * * * * *

Subpart C—Taxable Year for Which Deductions Taken

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SEC. 461. GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION.

(a) * * *

* * * * * * *

(i) SPECIAL RULES FOR TAX SHELTERS.—

(1) * * *

* * * * * * *

(3) TAX SHELTER DEFINED.—For purposes of this subsection, the term "tax shelter" means—

(A) * * *

* * * * * * *

(C) any tax shelter (as defined in [section 6662(d)(2)(C)(iii)] *section 6662(d)(2)(C)(ii)*).

* * * * * * *

SEC. 465. DEDUCTIONS LIMITED TO AMOUNT AT RISK.

(a) * * *

* * * * * * *

(c) ACTIVITIES TO WHICH SECTION APPLIES.—

(1) * * *

* * * * * * *

(7) EXCLUSION OF ACTIVE BUSINESSES OF QUALIFIED C CORPORATIONS.—

(A) * * *

(B) QUALIFIED C CORPORATION.—For purposes of subparagraph (A), the term "qualified C corporation" means any corporation described in subparagraph (B) of subsection (a)(1) which is not—

(i) a personal holding company (as defined in section 542(a)), *or*

[(ii) a foreign personal holding company (as defined in section 552(a)), or]

[(iii)] *(ii)* a personal service corporation (as defined in section 269A(b) but determined by substituting '5 percent' for '10 percent' in section 269A(b)(2)).

* * * * * * *

SEC. 468B. SPECIAL RULES FOR DESIGNATED SETTLEMENT FUNDS.

(a) * * *

* * * * * * *

[(g) CLARIFICATION OF TAXATION OF CERTAIN FUNDS.—Nothing in any provision of law shall be construed as providing that an escrow account, settlement fund, or similar fund is not subject to current income tax. The Secretary shall prescribe regulations providing for the taxation of any such account or fund whether as a grantor trust or otherwise.]

(g) CLARIFICATION OF TAXATION OF CERTAIN FUNDS.—

(1) IN GENERAL.—Except as provided in paragraph (2), nothing in any provision of law shall be construed as providing that an escrow account, settlement fund, or similar fund is not subject to current income tax. The Secretary shall prescribe regulations providing for the taxation of any such account or fund whether as a grantor trust or otherwise.

(2) EXEMPTION FROM TAX FOR CERTAIN SETTLEMENT FUNDS.—An escrow account, settlement fund, or similar fund shall be treated as beneficially owned by the United States and shall be exempt from taxation under this subtitle if—

(A) it is established pursuant to a consent decree entered by a judge of a United States District Court,

(B) it is created for the receipt of settlement payments as directed by a government entity for the sole purpose of resolving or satisfying one or more claims asserting liability under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980,

(C) the authority and control over the expenditure of funds therein (including the expenditure of contributions thereto and any net earnings thereon) is with such government entity, and

(D) upon termination, any remaining funds will be disbursed upon instructions by such government entity in accordance with applicable law.

For purposes of this paragraph, the term "government entity" means the United States, any State or political subdivision thereof, the District of Columbia, any possession of the United States, and any agency or instrumentality of any of the foregoing.

* * * * * * *

SEC. 469. PASSIVE ACTIVITY LOSSES AND CREDITS LIMITED.

(a) * * *

* * * * * * *

(k) SEPARATE APPLICATION OF SECTION IN CASE OF PUBLICLY TRADED PARTNERSHIPS.—

(1) * * *

* * * * * * *

(4) APPLICATION TO REGULATED INVESTMENT COMPANIES.—For purposes of this section, a regulated investment company (as defined in section 851) holding an interest in a qualified publicly traded partnership (as defined in section 851(h)) shall be treated as a taxpayer described in subsection (a)(2) with respect to items attributable to such interest.

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Subchapter F—Exempt Organizations

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PART I—GENERAL RULE

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SEC. 501. EXEMPTION FROM TAX ON CORPORATIONS, CERTAIN TRUSTS, ETC.

(a) * * *

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(c) LIST OF EXEMPT ORGANIZATIONS.—The following organizations are referred to in subsection (a):

(1) * * *

* * * * * * *

(15)[(A) Insurance companies or associations other than life (including interinsurers and reciprocal underwriters) if the net written premiums (or, if greater, direct written premiums) for the taxable year do not exceed $350,000.]

(A) Insurance companies (as defined in section 816(a)) other than life (including interinsurers and reciprocal underwriters) if—

(i) the gross receipts for the taxable year do not exceed $600,000, and

(ii) more than 50 percent of such gross receipts consist of premiums.

* * * * * * *

(C) For purposes of subparagraph (B), the term "controlled group" has the meaning given such term by section 831(b)(2)(B)(ii)*, except that in applying section 1563 for purposes of section 831(b)(2)(B)(ii), subparagraphs (B) and (C) of section 1563(b)(2) shall be disregarded*.

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PART II—PRIVATE FOUNDATIONS

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SEC. 508. SPECIAL RULES WITH RESPECT TO SECTION 501(c)(3)ORGANIZATIONS.

(a) * * *

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(d) DISALLOWANCE OF CERTAIN CHARITABLE, ETC., DEDUCTIONS.—

(1) GIFT OR BEQUEST TO ORGANIZATIONS SUBJECT TO SECTION 507(C) TAX.—No gift or bequest made to an organization upon which the tax provided by section 507(c) has been imposed shall be allowed as a deduction under section 170, 545(b)(2), ⟦556(b)(2),⟧ 642(c), 2055, 2106(a)(2), or 2522, if such gift or bequest is made—

(A) * * *

* * * * * * *

(2) GIFT OR BEQUEST TO TAXABLE PRIVATE FOUNDATION, SECTION 4947 TRUST, ETC.—No gift or bequest made to an organization shall be allowed as a deduction under section 170, 545(b)(2), ⟦556(b)(2),⟧ 642(c), 2055, 2106(a)(2), or 2522, if such gift or bequest is made—

(A) * * *

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PART III—TAXATION OF BUSINESS INCOME OF CERTAIN EXEMPT ORGANIZATIONS

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SEC. 512. UNRELATED BUSINESS TAXABLE INCOME.

(a) * * *

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(e) SPECIAL RULES APPLICABLE TO S CORPORATIONS.—

(1) IN GENERAL.—If an organization described in section *1361(c)(2)(A)(vi) or* 1361(c)(6) holds stock in an S corporation—

(A) * * *

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Subchapter G—Corporations Used to Avoid Income Tax on Shareholders

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PART I—CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS

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SEC. 535. ACCUMULATED TAXABLE INCOME.

(a) * * *

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(d) INCOME DISTRIBUTED TO UNITED STATES-OWNED FOREIGN CORPORATION RETAINS UNITED STATES CONNECTION.—

(1) * * *

(2) UNITED STATES-OWNED FOREIGN CORPORATION.—The term "United States-owned foreign corporation" has the meaning given to such term by ⟦section 904(g)(6)⟧ *section 904(h)(6)*.

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PART II—PERSONAL HOLDING COMPANIES

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SEC. 542. DEFINITION OF PERSONAL HOLDING COMPANY.

(a) * * *

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(c) EXCEPTIONS.—The term "personal holding company" as defined in subsection (a) does not include—

(1) * * *

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⟦(5) a foreign personal holding company as defined in section 552;⟧

(5) a foreign corporation,

* * * * * * *

⟦(7) a foreign corporation (other than a corporation which has income to which section 543(a)(7) applies for the taxable year), if all of its stock outstanding during the last half of the taxable year is owned by nonresident alien individuals, whether directly or indirectly through foreign estates, foreign trusts, foreign partnerships, or other foreign corporations;⟧

⟦(8)⟧ *(7)* a small business investment company which is licensed by the Small Business Administration and operating under the Small Business Investment Act of 1958 (15 U.S.C. 661 and following) and which is actively engaged in the business of providing funds to small business concerns under that Act. This paragraph shall not apply if any shareholder of the small business investment company owns at any time during the taxable year directly or indirectly (including, in the case of an individual, ownership by the members of his family as defined in section 544(a)(2) a 5 per centum or more proprietary interest in a small business concern to which funds are provided by the investment company or 5 per centum or more in value of the outstanding stock of such concern; *and*

⟦(9)⟧ *(8)* a corporation which is subject to the jurisdiction of the court in a title 11 or similar case (within the meaning of section 368(a)(3)(A)) unless a major purpose of instituting or continuing such case is the avoidance of the tax imposed by section 541⟦; and⟧.

⟦(10) a passive foreign investment company (as defined in section 1297.⟧

* * * * * * *

SEC. 543. PERSONAL HOLDING COMPANY INCOME

(a) * * *

(b) DEFINITIONS.—For purposes of this part—

(1) * * *

(A) all gains from the sale or other disposition of capital assets, *and*

(B) all gains (other than those referred to in subparagraph (A)) from the sale or other disposition of property described in section 1231(b)⟦, and⟧.

⟦(C) in the case of a foreign corporation all of the outstanding stock of which during the last half of the taxable year is owned by nonresident alien individuals (whether directly or indirectly through foreign estates, foreign trusts, foreign partnerships, or other foreign corporations), all items of income which would, but for this subparagraph, constitute personal holding company income under any paragraph of subsection (a) other than paragraph (7) thereof.⟧

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⟦PART III—FOREIGN PERSONAL HOLDING COMPANIES

⟦SEC. 551. FOREIGN PERSONAL HOLDING COMPANY INCOME TAXED TO UNITED STATES SHAREHOLDERS.

⟦(a) GENERAL RULE.—The undistributed foreign personal holding company income of a foreign personal holding company shall be included in the gross income of the citizens or residents of the United States, domestic corporations, domestic partnerships, and estates or trusts (other than foreign estates or trusts), who are shareholders in such foreign personal holding company (hereinafter called "United States shareholders") in the manner and to the extent set forth in this part.

⟦(b) AMOUNT INCLUDED IN GROSS INCOME.—Each United States shareholder, who was a shareholder on the day in the taxable year of the company which was the last day on which a United States group (as defined in section 552(a)(2)) existed with respect to the company, shall include in his gross income, as a dividend, for the taxable year in which or with which the taxable year of the company ends, the amount he would have received as a dividend (determined as if any distribution in liquidation actually made in such taxable year had not been made) if on such last day there had been distributed by the company, and received by the shareholders, an amount which bears the same ratio to the undistributed foreign personal holding company income of the company for the taxable year as the portion of such taxable year up to and including such last day bears to the entire taxable year.

⟦(c) INFORMATION IN RETURN.—Every United States shareholder who is required under subsection (b) to include in his gross income any amount with respect to the undistributed foreign personal holding company income of a foreign personal holding company and who, on the last day on which a United States group existed with respect to the company, owned 5 percent or more in value of the outstanding stock of such company, shall set forth in his return in complete detail the gross income, deductions and credits, taxable income, foreign personal holding company income, and undistributed foreign personal holding company income of such company.

⟦(d) EFFECT ON CAPITAL ACCOUNT OF FOREIGN PERSONAL HOLDING COMPANY.—An amount which bears the same ratio to the undistributed foreign personal holding company income of the foreign personal holding company for its taxable year as the portion of such taxable year up to and including the last day on which a United States group existed with respect to the company bears to the entire taxable year, shall, for the purpose of determining the effect of distributions in subsequent taxable years by the corporation, be considered as paid-in surplus or as a contribution to capital, and the accumulated earnings and profits as of the close of the taxable year shall be correspondingly reduced, if such amount or any portion thereof is required to be included as a dividend, directly or indirectly, in the gross income of United States shareholders.

⟦(e) BASIS OF STOCK IN HANDS OF SHAREHOLDERS.—The amount required to be included in the gross income of a United States shareholder under subsection (b) shall, for the purpose of adjusting the basis of his stock with respect to which the distribution would have been made (if it had been made), be treated as having been reinvested by the shareholder as a contribution to the capital of the corporation; but only to the extent to which such amount is included in his gross income in his return, increased or decreased by any adjustment of such amount in the last determination of the shareholder's tax liability, made before the expiration of 6 years after the date prescribed by law for filing the return.

⟦(f) STOCK HELD THROUGH FOREIGN ENTITY.—For purposes of this section, stock of a foreign personal holding company owned (directly or through the application of this subsection) by—

⟦(1) a foreign partnership or an estate or trust which is a foreign estate or trust, or

⟦(2) a foreign corporation which is not a foreign personal holding company,

shall be considered as being owned proportionately by its partners, beneficiaries, or shareholders. In any case to which the preceding sentence applies, the Secretary may by regulations provide that rules similar to the rules of section 1298(b)(5) shall apply, and provide for such other adjustments in the application of this subchapter as may be necessary to carry out the purposes of this subsection.

⟦(g) COORDINATION WITH PASSIVE FOREIGN INVESTMENT COMPANY PROVISIONS.—If, but for this subsection, an amount would be included in the gross income of any person under subsection (a) and under section 1293 (relating to current taxation of income from certain passive foreign investment companies), such amount shall be included in the gross income of such person only under subsection (a).

⟦(h) CROSS REFERENCES.—

⟦(1) For basis of stock or securities in a foreign personal holding company acquired from a decedent, see section 1014(b)(5).

⟦(2) For period of limitation on assessment and collection without assessment, in case of failure to include in gross income the amount properly includible therein under subsection (b), see section 6501.

⟦SEC. 552. DEFINITION OF FOREIGN PERSONAL HOLDING COMPANY.

⟦(a) GENERAL RULE.—For purposes of this subtitle, the term "foreign personal holding company" means any foreign corporation if—

⟦(1) GROSS INCOME REQUIREMENT.—At least 60 percent of its gross income (as defined in section 555(a)) for the taxable year is foreign personal holding company income as defined in section 553; but if the corporation is a foreign personal holding company with respect to any taxable year ending after August 26, 1937, then, for each subsequent taxable year, the minimum percentage shall be 50 percent in lieu of 60 percent, until a taxable year during the whole of which the stock ownership required by paragraph (2) does not exist, or until the expiration of three consecutive taxable years in each of which less than 50 percent of the gross income is foreign personal holding company income. For purposes of this paragraph, there shall be included in the gross income the amount includible therein as a dividend by reason of the application of section 555(c)(2); and

⟦(2) STOCK OWNERSHIP REQUIREMENT.—At any time during the taxable year more than 50 percent of—

⟦(A) the total combined voting power of all classes of stock of such corporation entitled to vote, or

⟦(B) the total value of the stock of such corporation,is owned (directly or indirectly) by or for not more than 5 individuals who are citizens or residents of the United States (hereinafter in this part referred to as the "United States group").

⟦(b) EXCEPTIONS.—The term "foreign personal holding company" does not include—

⟦(1) a corporation exempt from tax under subchapter F (sec. 501 and following); and

⟦(2) a corporation organized and doing business under the banking and credit laws of a foreign country if it is established (annually or at other periodic intervals) to the satisfaction of the Secretary that such corporation is not formed or availed of for the purpose of evading or avoiding United States income taxes which would otherwise be imposed upon its shareholders. If the Secretary is satisfied that such corporation is not so formed or availed of, he shall issue to such corporation annually or at other periodic intervals a certification that the corporation is not a foreign personal holding company.

Each United States shareholder of a foreign corporation which would, except for the provisions of paragraph (2), be a foreign personal holding company, shall attach to and file with his income tax return for the taxable year a copy of the certification by the Secretary made pursuant to paragraph (2). Such copy shall be filed with the taxpayer's return for the taxable year if he has been a shareholder of such corporation for any part of such year.

⟦(c) LOOK-THRU FOR CERTAIN DIVIDENDS AND INTEREST.—

⟦(1) IN GENERAL.—For purposes of this part, any related person dividend or interest shall be treated as foreign personal holding company income only to the extent such dividend or interest is attributable (determined under rules similar to the rules of subparagraphs (C) and (D) of section 904(d)(3)) to income of the related person which would be foreign personal holding company income.

⟦(2) RELATED PERSON DIVIDEND OR INTEREST.—For purposes of paragraph (1), the term "related person dividend or interest" means any dividend or interest which—

⟦(A) is described in subparagraph (A) of section 954(c)(3), and

⟦(B) is received from a related person which is not a foreign personal holding company (determined without regard to this subsection).

For purposes of the preceding sentence, the term "related person" has the meaning given such term by section 954(d)(3) (determined by substituting "foreign personal holding company" for "controlled foreign corporation" each place it appears).

⟦SEC. 553. FOREIGN PERSONAL HOLDING COMPANY INCOME.

⟦(a) FOREIGN PERSONAL HOLDING COMPANY INCOME.—For purposes of this subtitle, the term "foreign personal holding company income" means that portion of the gross income, determined for purposes of section 552, which consists of:

⟦(1) DIVIDENDS, ETC.—Dividends, interest, royalties, and annuities. This paragraph shall not apply to active business computer software royalties (as defined in section 543(d)).

⟦(2) STOCK AND SECURITIES TRANSACTIONS.—Except in the case of regular dealers in stock or securities, gains from the sale or exchange of stock or securities.

⟦(3) COMMODITIES TRANSACTIONS.—Gains from futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange. This paragraph shall not apply to gains by a producer, processor, merchant, or handler of the commodity which arise out of bona fide hedging transactions reasonably necessary to the conduct of its business in the manner in which such business is customarily and usually conducted by others.

⟦(4) ESTATES AND TRUSTS.—Amounts includible in computing the taxable income of the corporation under part I of subchapter J (sec. 641 and following, relating to estates, trusts, and beneficiaries); and gains from the sale or other disposition of any interest in an estate or trust.

⟦(5) PERSONAL SERVICE CONTRACTS.—

⟦(A) Amounts received under a contract under which the corporation is to furnish personal services; if some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description) in the contract; and

⟦(B) amounts received from the sale or other disposition of such a contract.

This paragraph shall apply with respect to amounts received for services under a particular contract only if at some time during the taxable year 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the individual who has performed, is to perform, or may be designated (by name or by description) as the one to perform, such services.

⟦(6) USE OF CORPORATION PROPERTY BY SHAREHOLDER.—Amounts received as compensation (however designated and from whomsoever received) for the use of, or right to use, property of the corporation in any case where, at any time during the taxable year, 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for an individual entitled to the use of the property; whether such right is obtained directly from the corporation or by means of a sublease or other arrangement. This paragraph shall apply only to a corporation which has foreign personal holding company income for the taxable year, computed without regard to this paragraph and paragraph (7), in excess of 10 percent of its gross income.

⟦(7) RENTS.—Rents, unless constituting 50 percent or more of the gross income. For purposes of this paragraph, the term "rents" means compensation, however designated, for the use of, or right to use, property, but does not include amounts constituting foreign personal holding company income under paragraph (6).

⟦(b) LIMITATION ON GROSS INCOME IN CERTAIN TRANSACTIONS.—For purposes of this part—

⟦(1) gross income and foreign personal holding company income determined with respect to transactions described in subsection (a)(2) (relating to gains from stock and security transactions) shall include only the excess of gains over losses from such transactions, and

⟦(2) gross income and foreign personal holding company income determined with respect to transactions described in subsection (a)(3) (relating to gains from commodity transactions) shall include only the excess of gains over losses from such transactions.

⟦SEC. 554. STOCK OWNERSHIP.

⟦(a) CONSTRUCTIVE OWNERSHIP.—For purposes of determining whether a corporation is a foreign personal holding company, insofar as such determination is based on stock ownership under section 552(a)(2), section 553(a)(5), or section 553(a)(6)—

⟦(1) STOCK NOT OWNED BY INDIVIDUAL.—Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries.

⟦(2) FAMILY AND PARTNERSHIP OWNERSHIP.—An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family or by or for his partner. For purposes of this paragraph, the family of an individual includes only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

[(3) OPTIONS.—If any person has an option to acquire stock, such stock shall be considered as owned by such person. For purposes of this paragraph, an option to acquire such an option, and each one of a series of such options, shall be considered as an option to acquire such stock.

[(4) APPLICATION OF FAMILY-PARTNERSHIP AND OPTION RULES.—Paragraphs (2) and (3) shall be applied—

[(A) for purposes of the stock ownership requirement provided in section 552(a)(2), if, but only if, the effect is to make the corporation a foreign personal holding company;

[(B) for purposes of section 553(a)(5) (relating to personal service contracts) or of section 553(a)(6) (relating to the use of property by shareholders), if, but only if, the effect is to make the amounts therein referred to includible under such paragraph as foreign personal holding company income.

[(5) CONSTRUCTIVE OWNERSHIP AS ACTUAL OWNERSHIP.—Stock constructively owned by a person by reason of the application of paragraph (1) or (3) shall, for purposes of applying paragraph (1) or (2), be treated as actually owned by such person; but stock constructively owned by an individual by reason of the application of paragraph (2) shall not be treated as owned by him for purposes of again applying such paragraph in order to make another the constructive owner of such stock.

[(6) OPTION RULE IN LIEU OF FAMILY AND PARTNERSHIP RULE.—If stock may be considered as owned by an individual under either paragraph (2) or (3) it shall be considered as owned by him under paragraph (3).

[(b) CONVERTIBLE SECURITIES.—Outstanding securities convertible into stock (whether or not convertible during the taxable year) shall be considered as outstanding stock—

[(1) for purposes of the stock ownership requirement provided in section 552(a)(2), but only if the effect of the inclusion of all such securities is to make the corporation a foreign personal holding company;

[(2) for purposes of section 553(a)(5) (relating to personal service contracts), but only if the effect of the inclusion of all such securities is to make the amounts therein referred to includible under such paragraph as foreign personal holding company income; and

[(3) for purposes of section 553(a)(6) (relating to the use of property by shareholders), but only if the effect of the inclusion of all such securities is to make the amounts therein referred to includible under such paragraph as foreign personal holding company income.

The requirement in paragraphs (1), (2), and (3) that all convertible securities must be included if any are to be included shall be subject to the exception that, where some of the outstanding securities are convertible only after a later date than in the case of others, the class having the earlier conversion date may be included although the others are not included, but no convertible securities shall be included unless all outstanding securities having a prior conversion date are also included.

⟦(c) SPECIAL RULES FOR APPLICATION OF SUBSECTION (A)(2).—For purposes of the stock ownership requirement provided in section 552(a)(2)—

⟦(1) stock owned by a nonresident alien individual (other than a foreign trust or foreign estate) shall not be considered by reason of so much of subsection (a)(2) as relates to attribution through family membership as owned by a citizen or by a resident alien individual who is not the spouse of the nonresident individual and who does not otherwise own stock in such corporation (determined after the application of subsection (a), other than attribution through family membership), and

⟦(2) stock of a corporation owned by any foreign person shall not be considered by reason of so much of subsection (a)(2) as relates to attribution through partners as owned by a citizen or resident of the United States who does not otherwise own stock in such corporation (determined after application of subsection (a) and paragraph (1), other than attribution through partners).

⟦SEC. 555. GROSS INCOME OF FOREIGN PERSONAL HOLDING COMPANIES.

⟦(a) GENERAL RULE.—For purposes of this part, the term "gross income" means, with respect to a foreign corporation, gross income computed (without regard to the provisions of subchapter N (sec. 861 and following)) as if the foreign corporation were a domestic corporation which is a personal holding company.

⟦(b) ADDITIONS TO GROSS INCOME.—In the case of a foreign personal holding company (whether or not a United States group, as defined in section 552(a)(2), existed with respect to such company on the last day of its taxable year) which was a shareholder in another foreign personal holding company on the day in the taxable year of the second company which was the last day on which a United States group existed with respect to the second company, there shall be included, as a dividend, in the gross income of the first company, for the taxable year in which or with which the taxable year of the second company ends, the amount the first company would have received as a dividend if on such last day there had been distributed by the second company, and received by the shareholders, an amount which bears the same ratio to the undistributed foreign personal holding company income of the second company for its taxable year as the portion of such taxable year up to and including such last day bears to the entire taxable year.

⟦(c) APPLICATION OF SUBSECTION (B).—The rule provided in subsection (b)—

⟦(1) shall be applied in the case of a foreign personal holding company for the purpose of determining its undistributed foreign personal holding company income which, or a part of which, is to be included in the gross income of its shareholders, whether United States shareholders or other foreign personal holding companies;

⟦(2) shall be applied in the case of every foreign corporation with respect to which a United States group exists on some day of its taxable year, for the purpose of determining whether such corporation meets the gross income requirements of section 552(a)(1).

[SEC. 556. UNDISTRIBUTED FOREIGN PERSONAL HOLDING COMPANY INCOME.

[(a) DEFINITION.—For purposes of this part, the term "undistributed foreign personal holding company income" means the taxable income of a foreign personal holding company adjusted in the manner provided in subsection (b), minus the dividends paid deduction (as defined in section 561).

[(b) ADJUSTMENTS TO TAXABLE INCOME.—For the purposes of subsection (a), the taxable income shall be adjusted as follows:

[(1) TAXES.—There shall be allowed as a deduction Federal income and excess profits taxes and income, war profits, and excess-profits taxes of foreign countries and possessions of the United States (to the extent not allowable as a deduction under section 275(a)(4)), accrued during the taxable year, but not including the accumulated earnings tax imposed by section 531, the personal holding company tax imposed by section 541, or the taxes imposed by corresponding sections of a prior income tax law.

[(2) CHARITABLE CONTRIBUTIONS.—The deduction for charitable contributions provided under section 170 shall be allowed, but in computing such deduction the limitations in section 170(b)(1)(A), (B), and (D) shall apply, and section 170(b)(2) and (d)(1) shall not apply. For purposes of this paragraph, the term "contribution base" when used in section 170(b)(1) means the taxable income computed with the adjustments (other than the 10-percent limitation) provided in section 170(b)(2) and (d)(1) and without the deduction of the amounts disallowed under paragraphs (5) and (6) of this subsection or the inclusion in gross income of the amounts includible therein as dividends by reason of the application of the provisions of section 555(b) (relating to the inclusion in gross income of a foreign personal holding company of its distributive share of the undistributed foreign personal holding company income of another company in which it is a shareholder).

[(3) SPECIAL DEDUCTIONS DISALLOWED.—The special deductions for corporations provided in part VIII (except section 248) of subchapter B (section 241 and following, relating to the deduction for dividends received by corporations, etc.) shall not be allowed.

[(4) NET OPERATING LOSS.—The net operating loss deduction provided in section 172 shall not be allowed, but there shall be allowed as a deduction the amount of the net operating loss (as defined in section 172(c)) for the preceding taxable year computed without the deductions provided in part VIII (except section 248) of subchapter B.

[(5) EXPENSES AND DEPRECIATION APPLICABLE TO PROPERTY OF THE TAXPAYER.—The aggregate of the deductions allowed under section 162 (relating to trade or business expenses) and section 167 (relating to depreciation) which are allocable to the operation and maintenance of property owned or operated by the company, shall be allowed only in an amount equal to the rent or other compensation received for the use of, or the right to use, the property, unless it is established (under regulations prescribed by the Secretary) to the satisfaction of the Secretary—

⟦(A) that the rent or other compensation received was the highest obtainable, or, if none was received, that none was obtainable;

⟦(B) that the property was held in the course of a business carried on bona fide for profit; and

⟦(C) either that there was reasonable expectation that the operation of the property would result in a profit, or that the property was necessary to the conduct of the business.

⟦(6) TAXES AND CONTRIBUTIONS TO PENSION TRUSTS.—The deductions provided in section 164(e) (relating to taxes of a shareholder paid by the corporation) and in section 404 (relating to pension, etc., trusts) shall not be allowed.

⟦SEC. 557. INCOME NOT PLACED ON ANNUAL BASIS.

⟦Section 443(b) (relating to computation of tax on change of annual accounting period) shall not apply in the computation of the undistributed foreign personal holding company income under section 556.

⟦SEC. 558. RETURNS OF OFFICERS, DIRECTORS, AND SHAREHOLDERS OF FOREIGN PERSONAL HOLDING COMPANIES.

⟦For provisions relating to returns of officers, directors, and shareholders of foreign personal holding companies, see section 6035.⟧

PART IV—DEDUCTION FOR DIVIDENDS PAID

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SEC. 562. RULES APPLICABLE IN DETERMINING DIVIDENDS ELIGIBLE FOR DIVIDENDS PAID DEDUCTION.

(a) * * *

(b) DISTRIBUTIONS IN LIQUIDATION.—

(1) Except in the case of a personal holding company described in section 542 ⟦or a foreign personal holding company described in section 552⟧—

(A) * * *

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SEC. 563. RULES RELATING TO DIVIDENDS PAID AFTER CLOSE OF TAXABLE YEAR.

(a) * * *

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⟦(c) FOREIGN PERSONAL HOLDING COMPANY TAX.—

⟦(1) IN GENERAL.—In the determination of the dividends paid deduction for purposes of part III, a dividend paid after the close of any taxable year and on or before the 15th day of the 3rd month following the close of such taxable year shall, to the extent the company designates such dividend as being taken into account under this subsection, be considered as paid during such taxable year. The amount allowed as a deduction by reason of the application of this subsection with respect to any taxable year shall not exceed the undistributed foreign personal holding company income of the corporation for the taxable year computed without regard to this subsection.

⟦(2) SPECIAL RULES.—In the case of any distribution referred to in paragraph (1)—

[(A) paragraph (1) shall apply only if such distribution is to the person who was the shareholder of record (as of the last day of the taxable year of the foreign personal holding company) with respect to the stock for which such distribution is made,

[(B) the determination of the person required to include such distribution in gross income shall be made under the principles of section 551(f), and

[(C) any person required to include such distribution in gross or distributable net income shall include such distribution in income for such person's taxable year in which the taxable year of the foreign personal holding company ends.]

[(d)] *(c)* DIVIDENDS CONSIDERED AS PAID ON LAST DAY OF TAXABLE YEAR.—For the purpose of applying section 562(a), with respect to distributions under [subsection (a), (b) or (c)] *subsection (a) or (b)* of this section, a distribution made after the close of a taxable year and on or before the 15th day of the third month following the close of the taxable year shall be considered as made on the last day of such taxable year.

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Subchapter H—Banking Institutions

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PART I—RULES OF GENERAL APPLICATION TO BANKING INSTITUTIONS

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SEC. 582. BAD DEBTS, LOSSES, AND GAINS WITH RESPECT TO SECURITIES HELD BY FINANCIAL INSTITUTIONS.

(a) * * *

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(c) BOND, ETC., LOSSES AND GAINS OF FINANCIAL INSTITUTIONS.—

(1) GENERAL RULE.—For purposes of this subtitle, in the case of a financial institution referred to in paragraph (2), the sale or exchange of a bond, debenture, note, or certificate or other evidence of indebtedness shall not be considered a sale or exchange of a capital asset. For purposes of the preceding sentence, any regular or residual interest in a REMIC[, and any regular interest in a FASIT,] shall be treated as an evidence of indebtedness.

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Subchapter I—Natural Resources

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PART III—SALES AND EXCHANGES

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SEC. 631. GAIN OR LOSS IN THE CASE OF TIMBER, COAL, OR DOMESTIC IRON ORE.

(a) * * *

(b) DISPOSAL OF TIMBER [WITH A RETAINED ECONOMIC INTEREST].—In the case of the disposal of timber held for more than 1 year before such disposal, by the owner thereof under any form or type of contract by virtue of which such owner [retains an economic interest in such timber] *either retains an economic interest in such timber or makes an outright sale of such timber*, the difference between the amount realized from the disposal of such timber and the adjusted depletion basis thereof, shall be considered as though it were a gain or loss, as the case may be, on the sale of such timber. In determining the gross income, the adjusted gross income, or the taxable income of the lessee, the deductions allowable with respect to rents and royalties shall be determined without regard to the provisions of this subsection. [The date of disposal] *In the case of disposal of timber with a retained economic interest, the date of disposal* of such timber shall be deemed to be the date such timber is cut, but if payment is made to the owner under the contract before such timber is cut the owner may elect to treat the date of such payment as the date of disposal of such timber. For purposes of this subsection, the term "owner" means any person who owns an interest in such timber, including a sublessor and a holder of a contract to cut timber.

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Subchapter K—Partners and Partnerships

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PART I—DETERMINATION OF TAX LIABILITY

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SEC. 704. PARTNER'S DISTRIBUTIVE SHARE.

(a) * * *

* * * * * * *

(c) CONTRIBUTED PROPERTY.—

(1) IN GENERAL.—Under regulations prescribed by the Secretary—

(A) income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution, [and]

(B) if any property so contributed is distributed (directly or indirectly) by the partnership (other than to the contributing partner) within 7 years of being contributed—

(i) * * *

* * * * * * *

(iii) appropriate adjustments shall be made to the adjusted basis of the contributing partner's interest in the partnership and to the adjusted basis of the property distributed to reflect any gain or loss recognized under this subparagraph[.], *and*

(C) if any property so contributed has a built-in loss—

(i) such built-in loss shall be taken into account only in determining the amount of items allocated to the contributing partner, and

(ii) except as provided in regulations, in determining the amount of items allocated to other partners, the basis of the contributed property in the hands of the partnership shall be treated as being equal to its fair market value at the time of contribution.

For purposes of subparagraph (C), the term "built-in loss" means the excess of the adjusted basis of the property (determined without regard to subparagraph (C)(ii)) over its fair market value at the time of contribution.

* * * * * * *

PART II—CONTRIBUTIONS, DISTRIBUTIONS, AND TRANSFERS

* * * * * * *

Subpart B—Distributions by a Partnership

* * * * * * *

[SEC. 734. OPTIONAL ADJUSTMENT TO BASIS OF UNDISTRIBUTED PARTNERSHIP PROPERTY.]

SEC. 734. ADJUSTMENT TO BASIS OF UNDISTRIBUTED PARTNERSHIP PROPERTY WHERE SECTION 754 ELECTION OR SUBSTANTIAL BASIS REDUCTION.

(a) GENERAL RULE.—The basis of partnership property shall not be adjusted as the result of a distribution of property to a partner unless the election, provided in section 754 (relating to optional adjustment to basis of partnership property), is in effect with respect to such partnership *or unless there is a substantial basis reduction*.

(b) METHOD OF ADJUSTMENT.—In the case of a distribution of property to a partner, a partnership, with respect to which the election provided in section 754 is in effect *or unless there is a substantial basis reduction*, shall—

(1) * * *

* * * * * * *

(d) SUBSTANTIAL BASIS REDUCTION.—

(1) IN GENERAL.—For purposes of this section, there is a substantial basis reduction with respect to a distribution if the sum of the amounts described in subparagraphs (A) and (B) of subsection (b)(2) exceeds $250,000.

(2) REGULATIONS.—

For regulations to carry out this subsection, see section 743(d)(2).

* * * * * * *

Subpart C—Transfers of Interests in a Partnership

* * * * * * *

[SEC. 743. OPTIONAL ADJUSTMENT TO BASIS OF PARTNERSHIP PROPERTY.]

SEC. 743. ADJUSTMENT TO BASIS OF PARTNERSHIP PROPERTY WHERE SECTION 754 ELECTION OR SUBSTANTIAL BUILT-IN LOSS.

(a) GENERAL RULE.—The basis of partnership property shall not be adjusted as the result of a transfer of an interest in a partnership by sale or exchange or on the death of a partner unless the election provided by section 754 (relating to optional adjustment to basis of partnership property) is in effect with respect to such partnership *or unless the partnership has a substantial built-in loss immediately after such transfer*.

(b) ADJUSTMENT TO BASIS OF PARTNERSHIP PROPERTY.—In the case of a transfer of an interest in a partnership by sale or exchange or upon the death of a partner, a partnership with respect to which the election provided in section 754 is in effect *or with respect to which there is a substantial built-in loss immediately after such transfer* shall—

(1) * * *

* * * * * * *

(d) SUBSTANTIAL BUILT-IN LOSS.—

(1) IN GENERAL.—For purposes of this section, a partnership has a substantial built-in loss with respect to a transfer of an interest in a partnership if the partnership's adjusted basis in the partnership property exceeds by more than $250,000 the fair market value of such property.

(2) REGULATIONS.—The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of paragraph (1) and section 734(d), including regulations aggregating related partnerships and disregarding property acquired by the partnership in an attempt to avoid such purposes.

* * * * * * *

Subpart D—Provisions Common to Other Subparts

* * * * * * *

SEC. 751. UNREALIZED RECEIVABLES AND INVENTORY ITEMS.

(a) * * *

* * * * * * *

(d) INVENTORY ITEMS.—For purposes of this subchapter, the term "inventory items" means—

(1) * * *

(2) any other property of the partnership which, on sale or exchange by the partnership, would be considered property other than a capital asset and other than property described in section 1231, *and*

[(3) any other property of the partnership which, if sold or exchanged by the partnership, would result in a gain taxable under subsection (a) of section 1246 (relating to gain on foreign investment company stock), and]

[(4)] *(3)* any other property held by the partnership which, if held by the selling or distributee partner, would be considered property of the type described in [paragraph (1), (2), or (3)] *paragraph (1) or (2)*.

* * * * * * *

SEC. 755. RULES FOR ALLOCATION OF BASIS.

(a) * * *

* * * * * * *

(c) NO ALLOCATION OF BASIS DECREASE TO STOCK OF CORPORATE PARTNER.—In making an allocation under subsection (a) of any decrease in the adjusted basis of partnership property under section 734(b)—

(1) no allocation may be made to stock in a corporation (or any person related (within the meaning of sections 267(b) and 707(b)(1)) to such corporation) which is a partner in the partnership, and

(2) any amount not allocable to stock by reason of paragraph (1) shall be allocated under subsection (a) to other partnership property.

Gain shall be recognized to the partnership to the extent that the amount required to be allocated under paragraph (2) to other partnership property exceeds the aggregate adjusted basis of such other property immediately before the allocation required by paragraph (2).

* * * * * * *

Subchapter L—Insurance Companies

* * * * * * *

PART II—OTHER INSURANCE COMPANIES

* * * * * * *

SEC. 831. TAX ON INSURANCE COMPANIES OTHER THAN LIFE INSURANCE COMPANIES.

(a) * * *

(b) ALTERNATIVE TAX FOR CERTAIN SMALL COMPANIES.—

(1) * * *

(2) COMPANIES TO WHICH THIS SUBSECTION APPLIES.—

(A) IN GENERAL.—This subsection shall apply to every insurance company other than life (including interinsurers and reciprocal underwriters) if—

(i) the net written premiums (or, if greater, direct written premiums) for the taxable year [exceed

$350,000 but] do not exceed [$1,200,000] *$1,890,000*, and

* * * * * * *

(C) INFLATION ADJUSTMENT.—In the case of any taxable year beginning in a calendar year after 2004, the $1,890,000 amount in subparagraph (A) shall be increased by an amount equal to—

(i) $1,890,000, multiplied by

(ii) the cost-of-living adjustment determined under section 1(f)(3) for such calendar year by substituting "calendar year 2003" for "calendar year 1992" in subparagraph (B) thereof.

If the amount as adjusted under the preceding sentence is not a multiple of $1,000, such amount shall be rounded to the next lowest multiple of $1,000.

* * * * * * *

(c) INSURANCE COMPANY DEFINED.—For purposes of this section, the term "insurance company" has the meaning given to such term by section 816(a).

[(c)] *(d)* CROSS REFERENCES.—

(1) * * *

* * * * * * *

PART III—PROVISIONS OF GENERAL APPLICATION

* * * * * * *

SEC. 845. CERTAIN REINSURANCE AGREEMENTS.

(a) ALLOCATION IN CASE OF REINSURANCE AGREEMENT INVOLVING TAX AVOIDANCE OR EVASION.—In the case of 2 or more related persons (within the meaning of section 482) who are parties to a reinsurance agreement (or where 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 such agreement or a conduit between related persons), the Secretary may—

(1) * * *

* * * * * * *

if he determines that such allocation, recharacterization, or adjustment is necessary to reflect the proper [source and character] *amount, source, or character* of the taxable income (or any item described in paragraph (1) relating to such taxable income) of each such person.

* * * * * * *

Subchapter M—Regulated Investment Companies and Real Estate Investment Trusts

Part I. Regulated investment companies.

* * * * * * *

[Part V. Financial asset securitization investment trusts.]

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PART I—REGULATED INVESTMENT COMPANIES

* * * * * * *

SEC. 851. DEFINITION OF REGULATED INVESTMENT COMPANY.

(a) * * *

(b) LIMITATIONS.—A corporation shall not be considered a regulated investment company for any taxable year unless—

(1) * * *

[(2) at least 90 percent of its gross income is derived from dividends, interest, payments with respect to securities loans (as defined in section 512(a)(5)), and gains from the sale or other disposition of stock or securities (as defined in section 2(a)(36) of the Investment Company Act of 1940, as amended) or foreign currencies, or other income (including but not limited to gains from options, futures, or forward contracts) derived with respect to its business of investing in such stock, securities, or currencies; and]

(2) at least 90 percent of its gross income is derived from—

(A) dividends, interest, payments with respect to securities loans (as defined in section 512(a)(5)), and gains from the sale or other disposition of stock or securities (as defined in section 2(a)(36) of the Investment Company Act of 1940, as amended) or foreign currencies, or other income (including but not limited to gains from options, futures or forward contracts) derived with respect to its business of investing in such stock, securities, or currencies, and

(B) distributions or other income derived from an interest in a qualified publicly traded partnership (as defined in subsection (h)); and

(3) at the close of each quarter of the taxable year—

(A) * * *

[(B) not more than 25 percent of the value of its total assets is invested in the securities (other than Government securities or the securities of other regulated investment companies) of any one issuer, or of two or more issuers which the taxpayer controls and which are determined, under regulations prescribed by the Secretary, to be engaged in the same or similar trades or businesses or related trades or businesses.]

(B) not more than 25 percent of the value of its total assets is invested in—

(i) the securities (other than Government securities or the securities of other regulated investment companies) of any one issuer,

(ii) the securities (other than the securities of other regulated investment companies) of two or more issuers which the taxpayer controls and which are determined, under regulations prescribed by the Secretary, to be engaged in the same or similar trades or businesses or related trades or businesses, or

(iii) the securities of one or more qualified publicly traded partnerships (as defined in subsection (h)).

For purposes of paragraph (2), there shall be treated as dividends amounts included in gross income under section 951(a)(1)(A)(i) or 1293(a) for the taxable year to the extent that, under section

959(a)(1) or 1293(c) (as the case may be), there is a distribution out of the earnings and profits of the taxable year which are attributable to the amounts so included. For purposes of paragraph (2), the Secretary may by regulation exclude from qualifying income foreign currency gains which are not directly related to the company's principal business of investing in stock or securities (or options and futures with respect to stock or securities). For purposes of paragraph (2), amounts excludable from gross income under section 103(a) shall be treated as included in gross income. Income derived from a partnership *(other than a qualified publicly traded partnership as defined in subsection (h))* or trust shall be treated as described in paragraph (2) only to the extent such income is attributable to items of income of the partnership or trust (as the case may be) which would be described in paragraph (2) if realized by the regulated investment company in the same manner as realized by the partnership or trust.

(c) RULES APPLICABLE TO SUBSECTION (B)(3).—For purposes of subsection (b)(3) and this subsection—

(1) * * *

* * * * * * *

(5) The term "outstanding voting securities of such issuer" shall include the equity securities of a qualified publicly traded partnership (as defined in subsection (h)).

【(5)】 *(6)* All other terms shall have the same meaning as when used in the Investment Company Act of 1940, as amended.

* * * * * * *

(h) QUALIFIED PUBLICLY TRADED PARTNERSHIP.—For purposes of this section, the term "qualified publicly traded partnership" means a publicly traded partnership described in section 7704(b) other than a partnership which would satisfy the gross income requirements of section 7704(c)(2) if qualifying income included only income described in subsection (b)(2)(A).

* * * * * * *

PART II—REAL ESTATE INVESTMENT TRUSTS

* * * * * * *

SEC. 856. DEFINITION OF REAL ESTATE INVESTMENT TRUST.

(a) * * *

* * * * * * *

(c) LIMITATIONS.—A corporation, trust, or association shall not be considered a real estate investment trust for any taxable year unless—

(1) * * *

* * * * * * *

(5) For purposes of this part—

(A) * * *

* * * * * * *

(E) A regular or residual interest in a REMIC shall be treated as a real estate asset, and any amount includible in gross income with respect to such an interest shall be treated as interest on an obligation secured by a mortgage on real property; except that, if less than 95 percent of the assets of such REMIC are real estate assets (determined as if the real estate investment trust held such assets), such real estate investment trust shall be treated as holding directly (and as receiving directly) its proportionate share of the assets and income of the REMIC. For purposes of determining whether any interest in a REMIC qualifies under the preceding sentence, any interest held by such REMIC in another REMIC shall be treated as a real estate asset under principles similar to the principles of the preceding sentence, except that, if such REMIC's are part of a tiered structure, they shall be treated as one REMIC for purposes of this subparagraph. ⟦The principles of the preceding provisions of this subparagraph shall apply to regular interests in a FASIT.⟧

* * * * * * *

⟦(G) TREATMENT OF CERTAIN HEDGING INSTRUMENTS.—Except to the extent provided by regulations, any—

⟦(i) payment to a real estate investment trust 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 trust to acquire or carry real estate assets, and

⟦(ii) gain from the sale or other disposition of any such investment,

shall be treated as income qualifying under paragraph (2).⟧

(G) TREATMENT OF CERTAIN HEDGING INSTRUMENTS.—Except to the extent provided by regulations, any income of a real estate investment trust from a hedging transaction (as defined in clause (ii) or (iii) of section 1221(b)(2)(A)) which is clearly identified pursuant to section 1221(a)(7), including gain from the sale or disposition of such a transaction, shall not constitute gross income under paragraph (2) to the extent that the transaction hedges any indebtedness incurred or to be incurred by the trust to acquire or carry real estate assets.

* * * * * * *

⟦(7) STRAIGHT DEBT SAFE HARBOR IN APPLYING PARAGRAPH (4).—Securities of an issuer which are straight debt (as defined in section 1361(c)(5) without regard to subparagraph (B)(iii) thereof) shall not be taken into account in applying paragraph (4)(B)(iii)(III) if—

⟦(A) the issuer is an individual, or

⟦(B) the only securities of such issuer which are held by the trust or a taxable REIT subsidiary of the trust are straight debt (as so defined), or

⟦(C) the issuer is a partnership and the trust holds at least a 20 percent profits interest in the partnership.⟧

(d) RENTS FROM REAL PROPERTY DEFINED.—

(1) * * *

*   *   *   *   *   *   *

(8) SPECIAL RULE FOR TAXABLE REIT SUBSIDIARIES.—For purposes of this subsection, amounts paid to a real estate investment trust by a taxable REIT subsidiary of such trust shall not be excluded from rents from real property by reason of paragraph (2)(B) if the requirements of either of the following subparagraphs are met:

[(A) LIMITED RENTAL EXCEPTION.—The requirements of this subparagraph are met with respect to any property if at least 90 percent of the leased space of the property is rented to persons other than taxable REIT subsidiaries of such trust and other than persons described in section 856(d)(2)(B). The preceding sentence shall apply only to the extent that the amounts paid to the trust as rents from real property (as defined in paragraph (1) without regard to paragraph (2)(B)) from such property are substantially comparable to such rents made by the other tenants of the trust's property for comparable space.]

(A) LIMITED RENTAL EXCEPTION.—

(i) IN GENERAL.—The requirements of this subparagraph are met with respect to any property if at least 90 percent of the leased space of the property is rented to persons other than taxable REIT subsidiaries of such trust and other than persons described in paragraph (2)(B).

(ii) RENTS MUST BE SUBSTANTIALLY COMPARABLE.—Clause (i) shall apply only to the extent that the amounts paid to the trust as rents from real property (as defined in paragraph (1) without regard to paragraph (2)(B)) from such property are substantially comparable to such rents paid by the other tenants of the trust's property for comparable space.

(iii) TIMES FOR TESTING RENT COMPARABILITY.—The substantial comparability requirement of clause (ii) shall be treated as met with respect to a lease to a taxable REIT subsidiary of the trust if such requirement is met under the terms of the lease—

(I) at the time such lease is entered into,

(II) at the time of each extension of the lease, including a failure to exercise a right to terminate, and

(III) at the time of any modification of the lease between the trust and the taxable REIT subsidiary if the rent under such lease is effectively increased pursuant to such modification.

With respect to subclause (III), if the taxable REIT subsidiary of the trust is a controlled taxable REIT subsidiary of the trust, the term "rents from real property" shall not in any event include rent under such lease to the extent of the increase in such rent on account of such modification.

(iv) CONTROLLED TAXABLE REIT SUBSIDIARY.—For purposes of clause (iii), the term "controlled taxable REIT subsidiary" means, with respect to any real es-

tate investment trust, any taxable REIT subsidiary of such trust if such trust owns directly or indirectly—

(I) stock possessing more than 50 percent of the total voting power of the outstanding stock of such subsidiary, or

(II) stock having a value of more than 50 percent of the total value of the outstanding stock of such subsidiary.

(v) CONTINUING QUALIFICATION BASED ON THIRD PARTY ACTIONS.—If the requirements of clause (i) are met at a time referred to in clause (iii), such requirements shall continue to be treated as met so long as there is no increase in the space leased to any taxable REIT subsidiary of such trust or to any person described in paragraph (2)(B).

(vi) CORRECTION PERIOD.—If there is an increase referred to in clause (v) during any calendar quarter with respect to any property, the requirements of clause (iii) shall be treated as met during the quarter and the succeeding quarter if such requirements are met at the close of such succeeding quarter.

* * * * * * *

(m) SAFE HARBOR IN APPLYING SUBSECTION (c)(4).—

(1) IN GENERAL.—In applying subclause (III) of subsection (c)(4)(B)(iii), except as otherwise determined by the Secretary in regulations, the following shall not be considered securities held by the trust:

(A) Straight debt securities of an issuer which meet the requirements of paragraph (2).

(B) Any loan to an individual or an estate.

(C) Any section 467 rental agreement (as defined in section 467(d)), other than with a person described in subsection (d)(2)(B).

(D) Any obligation to pay rents from real property (as defined in subsection (d)(1)).

(E) 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 subparagraph or payments on any obligation issued by such an entity,

(F) Any security issued by a real estate investment trust.

(G) Any other arrangement as determined by the Secretary.

(2) SPECIAL RULES RELATING TO STRAIGHT DEBT SECURITIES.—

(A) IN GENERAL.—For purposes of paragraph (1)(A), securities meet the requirements of this paragraph if such securities are straight debt, as defined in section 1361(c)(5) (without regard to subparagraph (B)(iii) thereof).

(B) SPECIAL RULES RELATING TO CERTAIN CONTINGENCIES.—For purposes of subparagraph (A), 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—

(i) any such contingency 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 1/4 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, or

(ii) neither the aggregate issue price nor the aggregate face amount of the issuer's debt instruments held by the trust exceeds $1,000,000 and not more than 12 months of unaccrued interest can be required to be prepaid thereunder.

(C) SPECIAL RULES RELATING TO CORPORATE OR PARTNERSHIP ISSUERS.—In the case of an issuer which is a corporation or a partnership, securities that otherwise would be described in paragraph (1)(A) shall be considered not to be so described if the trust holding such securities and any of its controlled taxable REIT subsidiaries (as defined in subsection (d)(8)(A)(iv)) hold any securities of the issuer which—

(i) are not described in paragraph (1) (prior to the application of this subparagraph), and

(ii) have an aggregate value greater than 1 percent of the issuer's outstanding securities determined without regard to paragraph (3)(A)(i).

(3) LOOK-THROUGH RULE FOR PARTNERSHIP SECURITIES.—

(A) IN GENERAL.—For purposes of applying subclause (III) of subsection (c)(4)(B)(iii)—

(i) a trust's interest as a partner in a partnership (as defined in section 7701(a)(2)) shall not be considered a security, and

(ii) the trust shall be deemed to own its proportionate share of each of the assets of the partnership.

(B) DETERMINATION OF TRUST'S INTEREST IN PARTNERSHIP ASSETS.—For purposes of subparagraph (A), with respect to any taxable year beginning after the date of the enactment of this subparagraph—

(i) the trust's interest in the partnership assets shall be the trust's proportionate interest in any securities issued by the partnership (determined without regard to subparagraph (A)(i) and paragraph (4), but not including securities described in paragraph (1)), and

(ii) the value of any debt instrument shall be the adjusted issue price thereof, as defined in section 1272(a)(4).

(4) CERTAIN PARTNERSHIP DEBT INSTRUMENTS NOT TREATED AS A SECURITY.—For purposes of applying subclause (III) of subsection (c)(4)(B)(iii)—

(A) any debt instrument issued by a partnership and not described in paragraph (1) shall not be considered a secu-

rity to the extent of the trust's interest as a partner in the partnership, and

(B) any debt instrument issued by a partnership and not described in paragraph (1) shall not be considered a security if at least 75 percent of the partnership's gross income (excluding gross income from prohibited transactions) is derived from sources referred to in subsection (c)(3).

(5) SECRETARIAL GUIDANCE.—The Secretary is authorized to provide guidance (including through the issuance of a written determination, as defined in section 6110(b)) that an arrangement shall not be considered a security held by the trust for purposes of applying subclause (III) of subsection (c)(4)(B)(iii) notwithstanding that such arrangement otherwise could be considered a security under subparagraph (F) of subsection (c)(5).

(n) LIMITATION ON DEDUCTION FOR INTEREST ON CERTAIN INDEBTEDNESS OF TAXABLE REIT SUBSIDIARY.—

(1) LIMITATION.—

(A) IN GENERAL.—If this subsection applies to any taxable REIT subsidiary for any taxable year, no deduction shall be allowed under this chapter for disqualified interest paid or accrued by such subsidiary during such taxable year. The amount disallowed under the preceding sentence shall not exceed the subsidiary's excess interest expense for the taxable year.

(B) DISALLOWED AMOUNT CARRIED TO SUCCEEDING TAXABLE YEAR.—Any amount disallowed under subparagraph (A) for any taxable year shall be treated as disqualified interest paid or accrued in the succeeding taxable year (and clause (ii) of paragraph (2)(A) shall not apply for purposes of applying this subsection to the amount so treated).

(2) SUBSIDIARIES TO WHICH SUBSECTION APPLIES.—

(A) IN GENERAL.—This subsection shall apply to any taxable REIT subsidiary for any taxable year if—

(i) such subsidiary has excess interest expense for such taxable year, and

(ii) the ratio of debt to equity of such subsidiary as of the close of such taxable year (or on any other day during the taxable year as the Secretary may by regulations prescribe) exceeds 1.5 to 1.

(B) EXCESS INTEREST EXPENSE.—

(i) IN GENERAL.—For purposes of this subsection, the term "excess interest expense" means the excess (if any) of—

(I) the taxable REIT subsidiary's net interest expense, over

(II) the sum of 50 percent of the adjusted taxable income of the subsidiary plus any excess limitation carryforward under clause (ii).

(ii) EXCESS LIMITATION CARRYFORWARD.—If a taxable REIT subsidiary has an excess limitation for any taxable year, the amount of such excess limitation shall be an excess limitation carryforward to the 1st succeeding taxable year and to the 2nd and 3rd succeeding taxable years to the extent not previously taken into account under this clause. The amount of such a carryforward

taken into account for any such succeeding taxable year shall not exceed the excess interest expense for such succeeding taxable year (determined without regard to the carryforward from the taxable year of such excess limitation).

(iii) EXCESS LIMITATION.—For purposes of clause (ii), the term "excess limitation" means the excess (if any) of—

(I) 50 percent of the adjusted taxable income of the subsidiary, over

(II) the subsidiary's net interest expense.

(C) RATIO OF DEBT TO EQUITY.—For purposes of this paragraph, the term "ratio of debt to equity" means the ratio which the total indebtedness of the subsidiary bears to the sum of its money and all other assets reduced (but not below zero) by such total indebtedness. The rules of section 163(j)(6)(E) shall apply for purposes of the preceding sentence.

(3) DISQUALIFIED INTEREST.—For purposes of this subsection, the term "disqualified interest" means any interest paid or accrued (directly or indirectly) by a taxable REIT subsidiary of a real estate investment trust to such trust.

(4) OTHER RULES TO APPLY.—Rules similar to the rules of paragraphs (7), (8), and (9) of section 163(j) shall apply for purposes of this subsection.

SEC. 857. TAXATION OF REAL ESTATE INVESTMENT TRUSTS AND THEIR BENEFICIARIES.

(a) * * *

(b) METHOD OF TAXATION OF REAL ESTATE INVESTMENT TRUSTS AND HOLDERS OF SHARES OR CERTIFICATES OF BENEFICIAL INTEREST.—

(1) * * *

* * * * * * *

(5) IMPOSITION OF TAX IN CASE OF FAILURE TO MEET CERTAIN REQUIREMENTS.—If section 856(c)(6) applies to a real estate investment trust for any taxable year, there is hereby imposed on such trust a tax in an amount equal to the greater of—

(A) the excess of—

(i) ❲90 percent❳ *95 percent* of the gross income (excluding gross income from prohibited transactions) of the real estate investment trust, over

* * * * * * *

(7) INCOME FROM REDETERMINED RENTS, REDETERMINED DEDUCTIONS, AND EXCESS INTEREST.—

(A) * * *

(B) REDETERMINED RENTS.—

(i) * * *

❲(ii) EXCEPTION FOR CERTAIN AMOUNTS.—Clause (i) shall not apply to amounts received directly or indirectly by a real estate investment trust—

❲(I) for services furnished or rendered by a taxable REIT subsidiary that are described in paragraph (1)(B) of section 856(d), or

【(II) from a taxable REIT subsidiary that are described in paragraph (7)(C)(ii) of such section.】

【(iii)】 *(ii)* EXCEPTION FOR DE MINIMIS AMOUNTS.—Clause (i) shall not apply to amounts described in section 856(d)(7)(A) with respect to a property to the extent such amounts do not exceed the one percent threshold described in section 856(d)(7)(B) with respect to such property.

【(iv)】 *(iii)* EXCEPTION FOR COMPARABLY PRICED SERVICES.—Clause (i) shall not apply to any service rendered by a taxable REIT subsidiary of a real estate investment trust to a tenant of such trust if—

(I) * * *

* * * * * * *

【(v)】 *(iv)* EXCEPTION FOR CERTAIN SEPARATELY CHARGED SERVICES.—Clause (i) shall not apply to any service rendered by a taxable REIT subsidiary of a real estate investment trust to a tenant of such trust if—

(I) * * *

* * * * * * *

【(vi)】 *(v)* EXCEPTION FOR CERTAIN SERVICES BASED ON SUBSIDIARY'S INCOME FROM THE SERVICES.—Clause (i) shall not apply to any service rendered by a taxable REIT subsidiary of a real estate investment trust to a tenant of such trust if the gross income of such subsidiary from such service is not less than 150 percent of such subsidiary's direct cost in furnishing or rendering the service.

【(vii)】 *(vi)* EXCEPTIONS GRANTED BY SECRETARY.—The Secretary may waive the tax otherwise imposed by subparagraph (A) if the trust establishes to the satisfaction of the Secretary that rents charged to tenants were established on an arms' length basis even though a taxable REIT subsidiary of the trust provided services to such tenants.

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PART IV—REAL ESTATE MORTGAGE INVESTMENT CONDUITS

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SEC. 860G. OTHER DEFINITIONS AND SPECIAL RULES.

(a) DEFINITIONS.—For purposes of this part—

(1) REGULAR INTEREST.—The term "regular interest" means any interest in a REMIC which is issued on the startup day with fixed terms and which is designated as a regular interest if—

(A) * * *

* * * * * * *

The interest shall not fail to meet the requirements of subparagraph (A) merely because the timing (but not the amount) of the principal payments (or other similar amounts) may be contingent on the extent of prepayments on qualified mortgages and the amount of income from permitted investments. *An interest shall not fail to qualify as a regular interest solely because the specified principal amount of the regular interest (or the amount of interest accrued on the regular interest) can be reduced as a result of the nonoccurrence of 1 or more contingent payments with respect to any reverse mortgage loan held by the REMIC if, on the startup day for the REMIC, the sponsor reasonably believes that all principal and interest due under the regular interest will be paid at or prior to the liquidation of the REMIC.*

* * * * * * *

(3) QUALIFIED MORTGAGE.—The term "qualified mortgage" means—

(A) any obligation (including any participation or certificate of beneficial ownership therein) which is principally secured by an interest in real property and which—

(i) is transferred to the REMIC on the startup day in exchange for regular or residual interests in the REMIC, ⟦or⟧

(ii) is purchased by the REMIC within the 3-month period beginning on the startup day if, except as provided in regulations, such purchase is pursuant to a fixed-price contract in effect on the startup day, *or*

(iii) represents an increase in the principal amount under the original terms of an obligation described in clause (i) or (ii) if—

(I) such increase in the balance is attributable to an advance made to the obligor pursuant to the original terms of the obligation,

(II) such increase in the balance occurs after the startup day, and

(III) such increase in the balance is purchased by the REMIC pursuant to a fixed price contract in effect on the startup day.

(B) any qualified replacement mortgage, *and*

(C) any regular interest in another REMIC transferred to the REMIC on the startup day in exchange for regular or residual interests in the REMIC⟦, and⟧.

⟦(D) any regular interest in a FASIT which is transferred to, or purchased by, the REMIC as described in clauses (i) and (ii) of subparagraph (A) but only if 95 percent or more of the value of the assets of such FASIT is at all times attributable to obligations described in subparagraph (A) (without regard to such clauses).⟧

For purposes of subparagraph (A) any obligation secured by stock held by a person as a tenant-stockholder (as defined in section 216) in a cooperative housing corporation (as so defined) shall be treated as secured by an interest in real property*, and any reverse mortgage loan (and each balance increase on such loan meeting the requirements of subparagraph (A)(iii)) shall be treated as an obligation secured by an interest in real property*. *For purposes of subparagraph (A), if more than 50 percent of the obligations transferred to, or purchased by, the*

REMIC are originated by the United States or any State (or any political subdivision, agency, or instrumentality of the United States or any State) and are principally secured by an interest in real property, then each obligation transferred to, or purchased by, the REMIC shall be treated as secured by an interest in real property.

* * * * * * *

(7) QUALIFIED RESERVE ASSET.—

(A) * * *

[(B) QUALIFIED RESERVE FUND.—For purposes of subparagraph (A), the term 'qualified reserve fund'means any reasonably required reserve to provide for full payment of expenses of the REMIC or amounts due on regular interests in the event of defaults on qualified mortgages or lower than expected returns on cash flow investments. The amount of any such reserve shall be promptly and appropriately reduced as payments of qualified mortgages are received.]

(B) QUALIFIED RESERVE FUND.—For purposes of subparagraph (A), the term "qualified reserve fund" means any reasonably required reserve to—

(i) provide for full payment of expenses of the REMIC or amounts due on regular interests in the event of defaults on qualified mortgages or lower than expected returns on cash flow investments, or

(ii) provide a source of funds for the purchase of obligations described in clause (ii) or (iii) of paragraph (3)(A).

The aggregate fair market value of the assets held in any such reserve shall not exceed 50 percent of the aggregate fair market value of all of the assets of the REMIC on the startup day, and the amount of any such reserve shall be promptly and appropriately reduced to the extent the amount held in such reserve is no longer reasonably required for purposes specified in clause (i) or (ii) of paragraph (3)(A).

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[PART V—FINANCIAL ASSET SECURITIZATION INVESTMENT TRUSTS

[SEC. 860H. TAXATION OF A FASIT; OTHER GENERAL RULES.

[(a) TAXATION OF FASIT.—A FASIT as such shall not be subject to taxation under this subtitle (and shall not be treated as a trust, partnership, corporation, or taxable mortgage pool).

[(b) TAXATION OF HOLDER OF THE OWNERSHIP INTEREST.—In determining the taxable income of the holder of the ownership interest in a FASIT—

⟦(1) all assets, liabilities, and items of income, gain, deduction, loss, and credit of a FASIT shall be treated as assets, liabilities, and such items (as the case may be) of such holder,

⟦(2) the constant yield method (including the rules of section 1272(a)(6)) shall be applied under an accrual method of accounting in determining all interest, acquisition discount, original issue discount, and market discount and all premium deductions or adjustments with respect to each debt instrument of the FASIT,

⟦(3) there shall not be taken into account any item of income, gain, or deduction allocable to a prohibited transaction, and

⟦(4) interest accrued by the FASIT which is exempt from tax imposed by this subtitle shall, when taken into account by such holder, be treated as ordinary income.

⟦(c) TREATMENT OF REGULAR INTERESTS.—For purposes of this title—

⟦(1) a regular interest in a FASIT, if not otherwise a debt instrument, shall be treated as a debt instrument,

⟦(2) section 163(e)(5) shall not apply to such an interest, and

⟦(3) amounts includible in gross income with respect to such an interest shall be determined under an accrual method of accounting.

⟦SEC. 860I. GAIN RECOGNITION ON CONTRIBUTIONS TO A FASIT AND IN OTHER CASES.

⟦(a) TREATMENT OF PROPERTY ACQUIRED BY FASIT.—

⟦(1) PROPERTY ACQUIRED FROM HOLDER OF OWNERSHIP INTEREST OR RELATED PERSON.—If property is sold or contributed to a FASIT by the holder of the ownership interest in such FASIT (or by a related person) gain (if any) shall be recognized to such holder (or person) in an amount equal to the excess (if any) of such property's value under subsection (d) on the date of such sale or contribution over its adjusted basis on such date.

⟦(2) PROPERTY ACQUIRED OTHER THAN FROM HOLDER OF THE OWNERSHIP INTEREST OR RELATED PERSON.—Property which is acquired by a FASIT other than in a transaction to which paragraph (1) applies shall be treated—

⟦(A) as having been acquired by the holder of the ownership interest in the FASIT for an amount equal to the FASIT's cost of acquiring such property, and

⟦(B) as having been sold by such holder to the FASIT at its value under subsection (d) on such date.

⟦(b) GAIN RECOGNITION ON PROPERTY OUTSIDE FASIT WHICH SUPPORTS REGULAR INTERESTS.—If property held by the holder of the ownership interest in a FASIT (or by any person related to such holder) supports any regular interest in such FASIT—

⟦(1) gain shall be recognized to such holder (or person) in the same manner as if such holder (or person) had sold such property at its value under subsection (d) on the earliest date such property supports such an interest, and

⟦(2) such property shall be treated as held by such FASIT for purposes of this part.

⟦(c) DEFERRAL OF GAIN RECOGNITION.—The Secretary may prescribe regulations which—

⟦(1) provide that gain otherwise recognized under subsection (a) or (b) shall not be recognized before the earliest date on which such property supports any regular interest in such FASIT or any indebtedness of the holder of the ownership interest (or of any person related to such holder), and

⟦(2) provide such adjustments to the other provisions of this part to the extent appropriate in the context of the treatment provided under paragraph (1).

⟦(d) VALUATION.—For purposes of this section—

⟦(1) IN GENERAL.—The value of any property under this subsection shall be—

⟦(A) in the case of a debt instrument which is not traded on an established securities market, the sum of the present values of the reasonably expected payments under such instrument determined (in the manner provided by regulations prescribed by the Secretary)—

⟦(i) as of the date of the event resulting in the gain recognition under this section, and

⟦(ii) by using a discount rate equal to 120 percent of the applicable Federal rate (as defined in section 1274(d)), or such other discount rate specified in such regulations, compounded semiannually, and

⟦(B) in the case of any other property, its fair market value.

⟦(2) SPECIAL RULE FOR REVOLVING LOAN ACCOUNTS.—For purposes of paragraph (1)—

⟦(A) each extension of credit (other than the accrual of interest) on a revolving loan account shall be treated as a separate debt instrument, and

⟦(B) payments on such extensions of credit having substantially the same terms shall be applied to such extensions beginning with the earliest such extension.

⟦(e) SPECIAL RULES.—

⟦(1) NONRECOGNITION RULES RULES NOT TO APPLY.—Gain required to be recognized under this section shall be recognized notwithstanding any other provision of this subtitle.

⟦(2) BASIS ADJUSTMENTS.—The basis of any property on which gain is recognized under this section shall be increased by the amount of gain so recognized.

⟦SEC. 860J. NON-FASIT LOSSES NOT TO OFFSET CERTAIN FASIT INCLUSIONS.

⟦(a) IN GENERAL.—The taxable income of the holder of the ownership interest or any high-yield interest in a FASIT for any taxable year shall in no event be less than the sum of—

⟦(1) such holder's taxable income determined solely with respect to such interests (including gains and losses from sales and exchanges of such interests), and

⟦(2) the excess inclusion (if any) under section 860E(a)(1) for such taxable year.

⟦(b) COORDINATION WITH SECTION 172.—Any increase in the taxable income of any holder of the ownership interest or a high- yield interest in a FASIT for any taxable year by reason of subsection (a) shall be disregarded—

⟦(1) in determining under section 172 the amount of any net operating loss for such taxable year, and

[(2) in determining taxable income for such taxable year for purposes of the second sentence of section 172(b)(2).

[(c) COORDINATION WITH MINIMUM TAX.—For purposes of part VI of subchapter A of this chapter—

[(1) the reference in section 55(b)(2) to taxable income shall be treated as a reference to taxable income determined without regard to this section,

[(2) the alternative minimum taxable income of any holder of the ownership interest or a high-yield interest in a FASIT for any taxable year shall in no event be less than such holder's taxable income determined solely with respect to such interests, and

[(3) any increase in taxable income under this section shall be disregarded for purposes of computing the alternative tax net operating loss deduction.

[(d) AFFILIATED GROUPS.—All members of an affiliated group filing a consolidated return shall be treated as one taxpayer for purposes of this section.

[SEC. 860K. TREATMENT OF TRANSFERS OF HIGH-YIELD INTERESTS TO DISQUALIFIED HOLDERS.

[(a) GENERAL RULE.—In the case of any high-yield interest which is held by a disqualified holder—

[(1) the gross income of such holder shall not include any income (other than gain) attributable to such interest, and

[(2) amounts not includible in the gross income of such holder by reason of paragraph (1) shall be included (at the time otherwise includible under paragraph (1)) in the gross income of the most recent holder of such interest which is not a disqualified holder.

[(b) EXCEPTIONS.—Rules similar to the rules of paragraphs (4) and (7) of section 860E(e) shall apply to the tax imposed by reason of the inclusion in gross income under subsection (a).

[(c) DISQUALIFIED HOLDER.—For purposes of this section, the term "disqualified holder" means any holder other than—

[(1) an eligible corporation (as defined in section 860L(a)(2)), or

[(2) a FASIT.

[(d) TREATMENT OF INTERESTS HELD BY SECURITIES DEALERS.—

[(1) IN GENERAL.—Subsection (a) shall not apply to any high-yield interest held by a disqualified holder if such holder is a dealer in securities who acquired such interest exclusively for sale to customers in the ordinary course of business (and not for investment).

[(2) CHANGE IN DEALER STATUS.—

[(A) IN GENERAL.—In the case of a dealer in securities which is not an eligible corporation (as defined in section 860L(a)(2)), if—

[(i) such dealer ceases to be a dealer in securities, or

[(ii) such dealer commences holding the high-yield interest for investment,

there is hereby imposed (in addition to other taxes) an excise tax equal to the product of the highest rate of tax specified in section 11(b)(1) and the income of such dealer attributable to such interest for periods after the date of such cessation or commencement.

[(B) HOLDING FOR 31 DAYS OR LESS.—For purposes of subparagraph (A)(ii), a dealer shall not be treated as holding an interest for investment before the thirty-second day after the date such dealer acquired such interest unless such interest is so held as part of a plan to avoid the purposes of this paragraph.

[(C) ADMINISTRATIVE PROVISIONS.—The deficiency procedures of subtitle F shall apply to the tax imposed by this paragraph.

[(e) TREATMENT OF HIGH-YIELD INTERESTS IN PASS-THRU ENTITIES.—

[(1) IN GENERAL.—If a pass-thru entity (as defined in section 860E(e)(6)) issues a debt or equity interest—

[(A) which is supported by any regular interest in a FASIT, and

[(B) which has an original yield to maturity which is greater than each of—

[(i) the sum determined under clauses (i) and (ii) of section 163(i)(1)(B) with respect to such debt or equity interest, and

[(ii) the yield to maturity to such entity on such regular interest (determined as of the date such entity acquired such interest),

there is hereby imposed on the pass-thru entity a tax (in addition to other taxes) equal to the product of the highest rate of tax specified in section 11(b)(1) and the income of the holder of such debt or equity interest which is properly attributable to such regular interest. For purposes of the preceding sentence, the yield to maturity of any equity interest shall be determined under regulations prescribed by the Secretary.

[(2) EXCEPTION.—Paragraph (1) shall not apply to arrangements not having as a principal purpose the avoidance of the purposes of this subsection.

[SEC. 860L. DEFINITIONS AND OTHER SPECIAL RULES.

[(a) FASIT.—

[(1) IN GENERAL.—For purposes of this title, the terms "financial asset securitization investment trust" and "FASIT" mean any entity—

[(A) for which an election to be treated as a FASIT applies for the taxable year,

[(B) all of the interests in which are regular interests or the ownership interest,

[(C) which has only one ownership interest and such ownership interest is held directly by an eligible corporation,

[(D) as of the close of the third month beginning after the day of its formation and at all times thereafter, substantially all of the assets of which (including assets treated as held by the entity under section 860I(b)(2)) consist of permitted assets, and

[(E) which is not described in section 851(a).

A rule similar to the rule of the last sentence of section 860D(a) shall apply for purposes of this paragraph.

⟦(2) ELIGIBLE CORPORATION.—For purposes of paragraph (1)(C), the term "eligible corporation" means any domestic C corporation other than—

⟦(A) a corporation which is exempt from, or is not subject to, tax under this chapter,

⟦(B) an entity described in section 851(a) or 856(a),

⟦(C) a REMIC, and

⟦(D) an organization to which part I of subchapter T applies.

⟦(3) ELECTION.—An entity (otherwise meeting the requirements of paragraph (1)) may elect to be treated as a FASIT. Except as provided in paragraph (5), such an election shall apply to the taxable year for which made and all subsequent taxable years unless revoked with the consent of the Secretary.

⟦(4) TERMINATION.—If any entity ceases to be a FASIT at any time during the taxable year, such entity shall not be treated as a FASIT after the date of such cessation.

⟦(5) INADVERTENT TERMINATIONS, ETC.—Rules similar to the rules of section 860D(b)(2)(B) shall apply to inadvertent failures to qualify or remain qualified as a FASIT.

⟦(6) PERMITTED ASSETS NOT TREATED AS INTEREST IN FASIT.—Except as provided in regulations prescribed by the Secretary, any asset which is a permitted asset at the time acquired by a FASIT shall not be treated at any time as an interest in such FASIT.

⟦(b) INTERESTS IN FASIT.—For purposes of this part—

⟦(1) REGULAR INTEREST.—

⟦(A) IN GENERAL.—The term "regular interest" means any interest which is issued by a FASIT on or after the startup date with fixed terms and which is designated as a regular interest if—

⟦(i) such interest unconditionally entitles the holder to receive a specified principal amount (or other similar amount),

⟦(ii) interest payments (or other similar amounts), if any, with respect to such interest are determined based on a fixed rate, or, except as otherwise provided by the Secretary, at a variable rate permitted under section 860G(a)(1)(B)(i),

⟦(iii) such interest does not have a stated maturity (including options to renew) greater than 30 years (or such longer period as may be permitted by regulations),

⟦(iv) the issue price of such interest does not exceed 125 percent of its stated principal amount, and

⟦(v) the yield to maturity on such interest is less than the sum determined under section 163(i)(1)(B) with respect to such interest.

An interest shall not fail to meet the requirements of clause (i) merely because the timing (but not the amount) of the principal payments (or other similar amounts) may be contingent on the extent that payments on debt instruments held by the FASIT are made in advance of anticipated payments and on the amount of income from permitted assets.

⟦(B) HIGH-YIELD INTERESTS.—

⟦(i) IN GENERAL.—The term "regular interest" includes any high-yield interest.

⟦(ii) HIGH-YIELD INTEREST.—The term "high-yield interest" means any interest which would be described in subparagraph (A) but for—

⟦(I) failing to meet the requirements of one or more of clauses (i), (iv), or (v) thereof, or

⟦(II) failing to meet the requirement of clause (ii) thereof but only if interest payments (or other similar amounts), if any, with respect to such interest consist of a specified portion of the interest payments on permitted assets and such portion does not vary during the period such interest is outstanding.

⟦(2) OWNERSHIP INTEREST.—The term "ownership interest" means the interest issued by a FASIT after the startup day which is designated as an ownership interest and which is not a regular interest.

⟦(c) PERMITTED ASSETS.—For purposes of this part—

⟦(1) IN GENERAL.—The term "permitted asset" means—

⟦(A) cash or cash equivalents,

⟦(B) any debt instrument (as defined in section 1275(a)(1)) under which interest payments (or other similar amounts), if any, at or before maturity meet the requirements applicable under clause (i) or (ii) of section 860G(a)(1)(B),

⟦(C) foreclosure property,

⟦(D) any asset—

⟦(i) which is an interest rate or foreign currency notional principal contract, letter of credit, insurance, guarantee against payment defaults, or other similar instrument permitted by the Secretary, and

⟦(ii) which is reasonably required to guarantee or hedge against the FASIT's risks associated with being the obligor on interests issued by the FASIT,

⟦(E) contract rights to acquire debt instruments described in subparagraph (B) or assets described in subparagraph (D),

⟦(F) any regular interest in another FASIT, and

⟦(G) any regular interest in a REMIC.

⟦(2) DEBT ISSUED BY HOLDER OF OWNERSHIP INTEREST NOT PERMITTED ASSET.—The term "permitted asset" shall not include any debt instrument issued by the holder of the ownership interest in the FASIT or by any person related to such holder or any direct or indirect interest in such a debt instrument. The preceding sentence shall not apply to cash equivalents and to any other investment specified in regulations prescribed by the Secretary.

⟦(3) FORECLOSURE PROPERTY.—

⟦(A) IN GENERAL.—The term "foreclosure property" means property—

❲(i) which would be foreclosure property under section 856(e) (determined without regard to paragraph (5) thereof) if such property were real property acquired by a real estate investment trust, and

❲(ii) which is acquired in connection with the default or imminent default of a debt instrument held by the FASIT unless the security interest in such property was created for the principal purpose of permitting the FASIT to invest in such property.

Solely for purposes of subsection (a)(1), the determination of whether any property is foreclosure property shall be made without regard to section 856(e)(4).

❲(B) AUTHORITY TO REDUCE GRACE PERIOD.—In the case of property other than real property and other than personal property incident to real property, the Secretary may by regulation reduce for purposes of subparagraph (A) the periods otherwise applicable under paragraphs (2) and (3) of section 856(e).

❲(d) STARTUP DAY.—For purposes of this part—

❲(1) IN GENERAL.—The term "startup day" means the date designated in the election under subsection (a)(3) as the startup day of the FASIT. Such day shall be the beginning of the first taxable year of the FASIT.

❲(2) TREATMENT OF PROPERTY HELD ON STARTUP DAY.—All property held (or treated as held under section 860I(b)(2)) by an entity as of the startup day shall be treated as contributed to such entity on such day by the holder of the ownership interest in such entity.

❲(e) TAX ON PROHIBITED TRANSACTIONS.—

❲(1) IN GENERAL.—There is hereby imposed for each taxable year of a FASIT a tax equal to 100 percent of the net income derived from prohibited transactions. Such tax shall be paid by the holder of the ownership interest in the FASIT.

❲(2) PROHIBITED TRANSACTION.—For purposes of this part, the term "prohibited transaction" means—

❲(A) except as provided in paragraph (3), the receipt of any income derived from any asset that is not a permitted asset,

❲(B) except as provided in paragraph (3), the disposition of any permitted asset other than foreclosure property,

❲(C) the receipt of any income derived from any loan originated by the FASIT, and

❲(D) the receipt of any income representing a fee or other compensation for services (other than any fee received as compensation for a waiver, amendment, or consent under permitted assets (other than foreclosure property) held by the FASIT).

❲(3) EXCEPTION FOR INCOME FROM CERTAIN DISPOSITIONS.—

❲(A) IN GENERAL.—Paragraph (2)(B) shall not apply to a disposition which would not be a prohibited transaction (as defined in section 860F(a)(2)) by reason of—

❲(i) clause (ii), (iii), or

❲(iv) of section 860F(a)(2)(A), or

❲(ii) section 860F(a)(5),

if the FASIT were treated as a REMIC and permitted assets (other than cash or cash equivalents) were treated as qualified mortgages.

⟦(B) SUBSTITUTION OF DEBT INSTRUMENTS; REDUCTION OF OVERCOLLATERIZATION.—Paragraph (2)(B) shall not apply to—

⟦(i) the substitution of a debt instrument described in subsection (c)(1)(B) for another debt instrument which is a permitted asset, or

⟦(ii) the distribution of a debt instrument contributed by the holder of the ownership interest to such holder in order to reduce over-collateralization of the FASIT,but only if a principal purpose of acquiring the debt instrument which is disposed of was not the recognition of gain (or the reduction of a loss) as a result of an increase in the market value of the debt instrument after its acquisition by the FASIT.

⟦(C) LIQUIDATION OF REGULAR INTERESTS.—Paragraph (2)(B) shall not apply to the complete liquidation of any class of regular interests.

⟦(D) INCOME FROM DISPOSITIONS OF FORMER HEDGE ASSETS.—Paragraph (2)(A) shall not apply to income derived from the disposition of—

⟦(i) an asset which was described in subsection (c)(1)(D) when first acquired by the FASIT but on the date of such disposition was no longer described in subsection (c)(1)(D)(ii), or

⟦(ii) a contract right to acquire an asset described in clause (i).

⟦(4) NET INCOME.—For purposes of this subsection, net income shall be determined in accordance with section 860F(a)(3).

⟦(f) COORDINATION WITH OTHER PROVISIONS.—

⟦(1) WASH SALES RULES.—Rules similar to the rules of section 860F(d) shall apply to the ownership interest in a FASIT.

⟦(2) SECTION 475.—Except as provided by the Secretary by regulations, if any security which is sold or contributed to a FASIT by the holder of the ownership interest in such FASIT was required to be marked-to-market under section 475 by such holder, section 475 shall continue to apply to such security; except that in applying section 475 while such security is held by the FASIT, the fair market value of such security for purposes of section 475 shall not be less than its value under section 860I(d).

⟦(g) RELATED PERSON.—For purposes of this part, a person (hereinafter in this subsection referred to as the "related person") is related to any person if—

⟦(1) the related person bears a relationship to such person specified in section 267(b) or section 707(b)(1), or

⟦(2) the related person and such person are engaged in trades or businesses under common control (within the meaning of subsections (a) and (b) of section 52).

For purposes of paragraph (1), in applying section 267(b) or 707(b)(1), "20 percent" shall be substituted for "50 percent'.

【(h) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this part, including regulations to prevent the abuse of the purposes of this part through transactions which are not primarily related to securitization of debt instruments by a FASIT.】

* * * * * * *

Subchapter N—Tax Based on Income From Sources Within or Without the United States

* * * * * * *

PART I—SOURCE RULES AND OTHER GENERAL RULES RELATING TO FOREIGN INCOME

* * * * * * *

SEC. 861. INCOME FROM SOURCES WITHIN THE UNITED STATES.

(a) GROSS INCOME FROM SOURCES WITHIN UNITED STATES.—The following items of gross income shall be treated as income from sources within the United States:

(1) * * *

(A) interest from a resident alien individual or domestic corporation, if such individual or corporation meets the 80-percent foreign business requirements of subsection (c)(1), 【and】

(B) interest—

(i) * * *

(ii) on amounts satisfying the requirements of subparagraph (B) of section 871(i)(3) which are paid by a foreign branch of a domestic corporation or a domestic partnership【.】*, and*

(C) in the case of a foreign partnership in which United States persons do not hold directly or indirectly 20 percent or more of either the capital or profits interests, any interest not paid by a trade or business engaged in by the partnership in the United States and not allocable to income which is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States.

* * * * * * *

SEC. 864. DEFINITIONS AND SPECIAL RULES.

(a) * * *

* * * * * * *

(d) TREATMENT OF RELATED PERSON FACTORING INCOME.—

(1) * * *

(2) PROVISIONS TO WHICH PARAGRAPH (1) APPLIES.—The provisions set forth in this paragraph are as follows:

【(A) Part III of subchapter G of this chapter (relating to foreign personal holding companies).】

【(B)】 *(A)* Section 904 (relating to limitation on foreign tax credit).

【(C)】 *(B)* Subpart F of part III of this subchapter (relating to controlled foreign corporations).

* * * * * * *

(5) CERTAIN PROVISIONS NOT TO APPLY.—

(A) CERTAIN EXCEPTIONS.—The following provisions shall not apply to any amount treated as interest under paragraph (1) or (6):

【(i) Subparagraphs (A)(iii)(II), (B)(ii), and (C)(iii)(III) of section 904(d)(2) (relating to exceptions for export financing interest).】

(i) Subclause (I) of section 904(d)(2)(B)(iii).

* * * * * * *

(e) RULES FOR ALLOCATING INTEREST, ETC.—For purposes of this subchapter—

(1) * * *

* * * * * * *

(7) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including regulations providing—

(A) * * *

(B) for direct allocation of interest expense incurred to carry out an integrated financial transaction to any interest (or interest-type income) derived from such transaction *and in other circumstances where such allocation would be appropriate to carry out the purposes of this subsection*,

* * * * * * *

(E) for appropriate adjustments in the application of paragraph (3) in the case of an insurance company, 【and】

(F) preventing assets or interest expense from being taken into account more than once, and

【(F)】 *(G)* that this subsection shall not apply for purposes of any provision of this subchapter to the extent the Secretary determines that the application of this subsection for such purposes would not be appropriate.

(f) ELECTION TO ALLOCATE INTEREST, ETC. ON WORLDWIDE BASIS.—For purposes of this subchapter, at the election of the worldwide affiliated group—

(1) ALLOCATION AND APPORTIONMENT OF INTEREST EXPENSE.—

(A) IN GENERAL.—The taxable income of each domestic corporation which is a member of a worldwide affiliated group shall be determined by allocating and apportioning interest expense of each member as if all members of such group were a single corporation.

(B) TREATMENT OF WORLDWIDE AFFILIATED GROUP.—The taxable income of the domestic members of a worldwide affiliated group from sources outside the United States shall be determined by allocating and apportioning the interest expense of such domestic members to such income in an amount equal to the excess (if any) of—

(i) the total interest expense of the worldwide affiliated group multiplied by the ratio which the foreign

assets of the worldwide affiliated group bears to all the assets of the worldwide affiliated group, over

(ii) the interest expense of all foreign corporations which are members of the worldwide affiliated group to the extent such interest expense of such foreign corporations would have been allocated and apportioned to foreign source income if this subsection were applied to a group consisting of all the foreign corporations in such worldwide affiliated group.

(C) WORLDWIDE AFFILIATED GROUP.—For purposes of this paragraph, the term "worldwide affiliated group" means a group consisting of—

(i) the includible members of an affiliated group (as defined in section 1504(a), determined without regard to paragraphs (2) and (4) of section 1504(b)), and

(ii) all controlled foreign corporations in which such members in the aggregate meet the ownership requirements of section 1504(a)(2) either directly or indirectly through applying paragraph (2) of section 958(a) or through applying rules similar to the rules of such paragraph to stock owned directly or indirectly by domestic partnerships, trusts, or estates.

(2) ALLOCATION AND APPORTIONMENT OF OTHER EXPENSES.—Expenses other than interest which are not directly allocable or apportioned to any specific income producing activity shall be allocated and apportioned as if all members of the affiliated group were a single corporation. For purposes of the preceding sentence, the term "affiliated group" has the meaning given such term by section 1504 (determined without regard to paragraph (4) of section 1504(b)).

(3) TREATMENT OF TAX-EXEMPT ASSETS; BASIS OF STOCK IN NONAFFILIATED 10-PERCENT OWNED CORPORATIONS.—The rules of paragraphs (3) and (4) of subsection (e) shall apply for purposes of this subsection; except that paragraph (4) shall be applied on worldwide affiliated group basis.

(4) TREATMENT OF CERTAIN FINANCIAL INSTITUTIONS.—

(A) IN GENERAL.—For purposes of paragraph (1), any corporation described in subparagraph (B) shall be treated as an includible corporation for purposes of section 1504 only for purposes of applying this subsection separately to corporations so described.

(B) DESCRIPTION.—A corporation is described in this subparagraph if—

(i) such corporation is a financial institution described in section 581 or 591,

(ii) the business of such financial institution is predominantly with persons other than related persons (within the meaning of subsection (d)(4)) or their customers, and

(iii) such financial institution is required by State or Federal law to be operated separately from any other entity which is not such an institution.

(C) TREATMENT OF BANK HOLDING COMPANIES.—To the extent provided in regulations—

(i) a bank holding company (within the meaning of section 2(a) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(a))),

(ii) a financial holding company (within the meaning of section 2(p) of such Act), and

(iii) any subsidiary of a financial institution described in section 581 or 591, or any such bank or financial holding company, if such subsidiary is predominantly engaged (directly or indirectly) in the active conduct of a banking, financing, or similar business,

shall be treated as a corporation described in subparagraph (B).

(5) ELECTION TO EXPAND FINANCIAL INSTITUTION GROUP OF WORLDWIDE GROUP.—

(A) IN GENERAL.—If a worldwide affiliated group elects the application of this subsection, all financial corporations which—

(i) are members of such worldwide affiliated group, but

(ii) are not corporations described in paragraph (4)(B),

shall be treated as described in paragraph (4)(B) for purposes of applying paragraph (4)(A). This subsection (other than this paragraph) shall apply to any such group in the same manner as this subsection (other than this paragraph) applies to the pre-election worldwide affiliated group of which such group is a part.

(B) FINANCIAL CORPORATION.—For purposes of this paragraph, the term "financial corporation" means any corporation if at least 80 percent of its gross income is income described in section 904(d)(2)(D)(ii) and the regulations thereunder which is derived from transactions with persons who are not related (within the meaning of section 267(b) or 707(b)(1)) to the corporation. For purposes of the preceding sentence, there shall be disregarded any item of income or gain from a transaction or series of transactions a principal purpose of which is the qualification of any corporation as a financial corporation.

(C) ANTIABUSE RULES.—In the case of a corporation which is a member of an electing financial institution group, to the extent that such corporation—

(i) distributes dividends or makes other distributions with respect to its stock after the date of the enactment of this paragraph to any member of the pre-election worldwide affiliated group (other than to a member of the electing financial institution group) in excess of the greater of—

(I) its average annual dividend (expressed as a percentage of current earnings and profits) during the 5-taxable-year period ending with the taxable year preceding the taxable year, or

(II) 25 percent of its average annual earnings and profits for such 5-taxable-year period, or

(ii) deals with any person in any manner not clearly reflecting the income of the corporation (as determined under principles similar to the principles of section 482),

an amount of indebtedness of the electing financial institution group equal to the excess distribution or the understatement or overstatement of income, as the case may be, shall be recharacterized (for the taxable year and subsequent taxable years) for purposes of this paragraph as indebtedness of the worldwide affiliated group (excluding the electing financial institution group). If a corporation has not been in existence for 5 taxable years, this subparagraph shall be applied with respect to the period it was in existence.

(D) ELECTION.—An election under this paragraph with respect to any financial institution group may be made only by the common parent of the pre-election worldwide affiliated group and may be made only for the first taxable year beginning after December 31, 2008, in which such affiliated group includes 1 or more financial corporations. Such an election, once made, shall apply to all financial corporations which are members of the electing financial institution group for such taxable year and all subsequent years unless revoked with the consent of the Secretary.

(E) DEFINITIONS RELATING TO GROUPS.—For purposes of this paragraph—

(i) PRE-ELECTION WORLDWIDE AFFILIATED GROUP.—The term "pre-election worldwide affiliated group" means, with respect to a corporation, the worldwide affiliated group of which such corporation would (but for an election under this paragraph) be a member for purposes of applying paragraph (1).

(ii) ELECTING FINANCIAL INSTITUTION GROUP.—The term "electing financial institution group" means the group of corporations to which this subsection applies separately by reason of the application of paragraph (4)(A) and which includes financial corporations by reason of an election under subparagraph (A).

(F) REGULATIONS.—The Secretary shall prescribe such regulations as may be appropriate to carry out this subsection, including regulations—

(i) providing for the direct allocation of interest expense in other circumstances where such allocation would be appropriate to carry out the purposes of this subsection,

(ii) preventing assets or interest expense from being taken into account more than once, and

(iii) dealing with changes in members of any group (through acquisitions or otherwise) treated under this paragraph as an affiliated group for purposes of this subsection.

(6) ELECTION.—An election to have this subsection apply with respect to any worldwide affiliated group may be made only by the common parent of the domestic affiliated group referred to in paragraph (1)(C) and may be made only for the first taxable

year beginning after December 31, 2008, in which a worldwide affiliated group exists which includes such affiliated group and at least one foreign corporation. Such an election, once made, shall apply to such common parent and all other corporations which are members of such worldwide affiliated group for such taxable year and all subsequent years unless revoked with the consent of the Secretary.

[(f)] *(g)* ALLOCATION OF RESEARCH AND EXPERIMENTAL EXPENDITURES.—

(1) * * *

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PART II—NONRESIDENT ALIENS AND FOREIGN CORPORATIONS

* * * * * * *

Subpart A—Nonresident Alien Individuals

* * * * * * *

SEC. 871. TAX ON NONRESIDENT ALIEN INDIVIDUALS.

(a) * * *

* * * * * * *

(i) TAX NOT TO APPLY TO CERTAIN INTEREST AND DIVIDENDS.—

(1) IN GENERAL.—No tax shall be imposed under paragraph (1)(A) or (1)(C) of subsection (a) on any amount described in paragraph (2).

(2) AMOUNTS TO WHICH PARAGRAPH (1) APPLIES.—The amounts described in this paragraph are as follows:

(A) * * *

* * * * * * *

(D) Dividends paid by a foreign corporation which are treated under section 861(a)(2)(B) as income from sources within the United States.

* * * * * * *

(k) EXEMPTION FOR CERTAIN DIVIDENDS OF REGULATED INVESTMENT COMPANIES.—

(1) INTEREST-RELATED DIVIDENDS.—

(A) IN GENERAL.—Except as provided in subparagraph (B), no tax shall be imposed under paragraph (1)(A) of subsection (a) on any interest-related dividend received from a regulated investment company.

(B) EXCEPTIONS.—Subparagraph (A) shall not apply—

(i) to any interest-related dividend received from a regulated investment company by a person to the extent such dividend is attributable to interest (other than interest described in subparagraph (E) (i) or (iii)) received by such company on indebtedness issued by such person or by any corporation or partnership with respect to which such person is a 10-percent shareholder,

(ii) to any interest-related dividend with respect to stock of a regulated investment company unless the person who would otherwise be required to deduct and withhold tax from such dividend under chapter 3 re-

ceives a statement (which meets requirements similar to the requirements of subsection (h)(5)) that the beneficial owner of such stock is not a United States person, and

(iii) to any interest-related dividend paid to any person within a foreign country (or any interest-related dividend payment addressed to, or for the account of, persons within such foreign country) during any period described in subsection (h)(6) with respect to such country.

Clause (iii) shall not apply to any dividend with respect to any stock which was acquired on or before the date of the publication of the Secretary's determination under subsection (h)(6).

(C) INTEREST-RELATED DIVIDEND.—For purposes of this paragraph, an interest-related dividend is any dividend (or part thereof) which is designated by the regulated investment company as an interest-related dividend in a written notice mailed to its shareholders not later than 60 days after the close of its taxable year. If the aggregate amount so designated with respect to a taxable year of the company (including amounts so designated with respect to dividends paid after the close of the taxable year described in section 855) is greater than the qualified net interest income of the company for such taxable year, the portion of each distribution which shall be an interest-related dividend shall be only that portion of the amounts so designated which such qualified net interest income bears to the aggregate amount so designated.

(D) QUALIFIED NET INTEREST INCOME.—For purposes of subparagraph (C), the term "qualified net interest income" means the qualified interest income of the regulated investment company reduced by the deductions properly allocable to such income.

(E) QUALIFIED INTEREST INCOME.—For purposes of subparagraph (D), the term "qualified interest income" means the sum of the following amounts derived by the regulated investment company from sources within the United States:

(i) Any amount includible in gross income as original issue discount (within the meaning of section 1273) on an obligation payable 183 days or less from the date of original issue (without regard to the period held by the company).

(ii) Any interest includible in gross income (including amounts recognized as ordinary income in respect of original issue discount or market discount or acquisition discount under part V of subchapter P and such other amounts as regulations may provide) on an obligation which is in registered form; except that this clause shall not apply to—

(I) any interest on an obligation issued by a corporation or partnership if the regulated investment company is a 10-percent shareholder in such corporation or partnership, and

(II) any interest which is treated as not being portfolio interest under the rules of subsection (h)(4).

(iii) Any interest referred to in subsection (i)(2)(A) (without regard to the trade or business of the regulated investment company).

(iv) Any interest-related dividend includable in gross income with respect to stock of another regulated investment company.

(F) 10-PERCENT SHAREHOLDER.—For purposes of this paragraph, the term "10-percent shareholder" has the meaning given such term by subsection (h)(3)(B).

(2) SHORT-TERM CAPITAL GAIN DIVIDENDS.—

(A) IN GENERAL.—Except as provided in subparagraph (B), no tax shall be imposed under paragraph (1)(A) of subsection (a) on any short-term capital gain dividend received from a regulated investment company.

(B) EXCEPTION FOR ALIENS TAXABLE UNDER SUBSECTION (a)(2).—Subparagraph (A) shall not apply in the case of any nonresident alien individual subject to tax under subsection (a)(2).

(C) SHORT-TERM CAPITAL GAIN DIVIDEND.—For purposes of this paragraph, a short-term capital gain dividend is any dividend (or part thereof) which is designated by the regulated investment company as a short-term capital gain dividend in a written notice mailed to its shareholders not later than 60 days after the close of its taxable year. If the aggregate amount so designated with respect to a taxable year of the company (including amounts so designated with respect to dividends paid after the close of the taxable year described in section 855) is greater than the qualified short-term gain of the company for such taxable year, the portion of each distribution which shall be a short-term capital gain dividend shall be only that portion of the amounts so designated which such qualified short-term gain bears to the aggregate amount so designated.

(D) QUALIFIED SHORT-TERM GAIN.—For purposes of subparagraph (C), the term "qualified short-term gain" means the excess of the net short-term capital gain of the regulated investment company for the taxable year over the net long-term capital loss (if any) of such company for such taxable year. For purposes of this subparagraph—

(i) the net short-term capital gain of the regulated investment company shall be computed by treating any short-term capital gain dividend includible in gross income with respect to stock of another regulated investment company as a short-term capital gain, and

(ii) the excess of the net short-term capital gain for a taxable year over the net long-term capital loss for a taxable year (to which an election under section 4982(e)(4) does not apply) shall be determined without regard to any net capital loss or net short-term capital loss attributable to transactions after October 31 of such year, and any such net capital loss or net short-

term capital loss shall be treated as arising on the 1st day of the next taxable year.

To the extent provided in regulations, clause (ii) shall apply also for purposes of computing the taxable income of the regulated investment company.

[(k)] *(l)* CROSS REFERENCES.—

(1) For tax treatment of certain amounts distributed by the United States to nonresident alien individuals, see section 402(e)(2).

* * * * * * *

SEC. 877. EXPATRIATION TO AVOID TAX.

[(a) TREATMENT OF EXPATRIATES.—

[(1) IN GENERAL.—Every nonresident alien individual who, within the 10-year period immediately preceding the close of the taxable year, lost United States citizenship, unless such loss did not have for one of its principal purposes the avoidance of taxes under this subtitle or subtitle B, shall be taxable for such taxable year in the manner provided in subsection (b) if the tax imposed pursuant to such subsection (after any reduction in such tax under the last sentence of such subsection) exceeds the tax which, without regard to this section, is imposed pursuant to section 871.

[(2) CERTAIN INDIVIDUALS TREATED AS HAVING TAX AVOIDANCE PURPOSE.—For purposes of paragraph (1), an individual shall be treated as having a principal purpose to avoid such taxes if—

[(A) the average annual net income tax (as defined in section 38(c)(1) of such individual for the period of 5 taxable years ending before the date of the loss of United States citizenship is greater than $100,000, or

[(B) the net worth of the individual as of such date is $500,000 or more.

In the case of the loss of United States citizenship in any calendar year after 1996, such $100,000 and $500,000 amounts shall be increased by an amount equal to such dollar amount multiplied by the cost-of-living adjustment determined under section 1(f)(3) for such calendar year by substituting "1994" for "1992" in subparagraph (B) thereof. Any increase under the preceding sentence shall be rounded to the nearest multiple of $1,000.]

(a) TREATMENT OF EXPATRIATES.—

(1) IN GENERAL.—Every nonresident alien individual to whom this section applies and who, within the 10-year period immediately preceding the close of the taxable year, lost United States citizenship shall be taxable for such taxable year in the manner provided in subsection (b) if the tax imposed pursuant to such subsection (after any reduction in such tax under the last sentence of such subsection) exceeds the tax which, without regard to this section, is imposed pursuant to section 871.

(2) INDIVIDUALS SUBJECT TO THIS SECTION.—This section shall apply to any individual if—

(A) the average annual net income tax (as defined in section 38(c)(1)) of such individual for the period of 5 taxable years ending before the date of the loss of United States citizenship is greater than $122,000,

(B) the net worth of the individual as of such date is $2,000,000 or more, or

(C) such individual fails to certify under penalty of perjury that he has met the requirements of this title for the 5 preceding taxable years or fails to submit such evidence of such compliance as the Secretary may require.

In the case of the loss of United States citizenship in any calendar year after 2003, such $122,000 amount shall be increased by an amount equal to such dollar amount multiplied by the cost-of-living adjustment determined under section 1(f)(3) for such calendar year by substituting "2002" for "1992" in subparagraph (B) thereof. Any increase under the preceding sentence shall be rounded to the nearest multiple of $1,000.

* * * * * * *

【(c) TAX AVOIDANCE NOT PRESUMED IN CERTAIN CASES.—

【(1) IN GENERAL.—Subsection (a)(2) shall not apply to an individual if—

【(A) such individual is described in a subparagraph of paragraph (2) of this subsection, and

【(B) within the 1-year period beginning on the date of the loss of United States citizenship, such individual submits a ruling request for the Secretary's determination as to whether such loss has for one of its principal purposes the avoidance of taxes under this subtitle or subtitle B.

【(2) INDIVIDUALS DESCRIBED.—

【(A) DUAL CITIZENSHIP, ETC.—An individual is described in this subparagraph if—

【(i) the individual became at birth a citizen of the United States and a citizen of another country and continues to be a citizen of such other country, or

【(ii) the individual becomes (not later than the close of a reasonable period after loss of United States citizenship) a citizen of the country in which—

【(I) such individual was born,

【(II) if such individual is married, such individual's spouse was born, or

【(III) either of such individual's parents were born.

【(B) LONG-TERM FOREIGN RESIDENTS.—An individual is described in this subparagraph if, for each year in the 10-year period ending on the date of loss of United States citizenship, the individual was present in the United States for 30 days or less. The rule of section 7701(b)(3)(D)(ii) shall apply for purposes of this subparagraph.

【(C) RENUNCIATION UPON REACHING AGE OF MAJORITY.—An individual is described in this subparagraph if the individual's loss of United States citizenship occurs before such individual attains age 18-1/2.

【(D) INDIVIDUALS SPECIFIED IN REGULATIONS.—An individual is described in this subparagraph if the individual is described in a category of individuals prescribed by regulation by the Secretary.】

(c) EXCEPTIONS.—

(1) IN GENERAL.—Subparagraphs (A) and (B) of subsection (a)(2) shall not apply to an individual described in paragraph (2) or (3).

(2) DUAL CITIZENS.—

(A) IN GENERAL.—An individual is described in this paragraph if—

(i) the individual became at birth a citizen of the United States and a citizen of another country and continues to be a citizen of such other country, and

(ii) the individual has had no substantial contacts with the United States.

(B) SUBSTANTIAL CONTACTS.—An individual shall be treated as having no substantial contacts with the United States only if the individual—

(i) was never a resident of the United States (as defined in section 7701(b)),

(ii) has never held a United States passport, and

(iii) was not present in the United States for more than 30 days during any calendar year which is 1 of the 10 calendar years preceding the individual's loss of United States citizenship.

(3) CERTAIN MINORS.—An individual is described in this paragraph if—

(A) the individual became at birth a citizen of the United States,

(B) neither parent of such individual was a citizen of the United States at the time of such birth,

(C) the individual's loss of United States citizenship occurs before such individual attains age 18½, and

(D) the individual was not present in the United States for more than 30 days during any calendar year which is 1 of the 10 calendar years preceding the individual's loss of United States citizenship.

* * * * * * *

(g) PHYSICAL PRESENCE.—

(1) IN GENERAL.—This section shall not apply to any individual to whom this section would otherwise apply for any taxable year during the 10-year period referred to in subsection (a) in which such individual is physically present in the United States at any time on more than 30 days in the calendar year ending in such taxable year, and such individual shall be treated for purposes of this title as a citizen or resident of the United States, as the case may be, for such taxable year.

(2) EXCEPTION.—

(A) IN GENERAL.—In the case of an individual described in any of the following subparagraphs of this paragraph, a day of physical presence in the United States shall be disregarded if the individual is performing services in the United States on such day for an employer. The preceding sentence shall not apply if—

(i) such employer is related (within the meaning of section 267 and 707) to such individual, or

(ii) such employer fails to meet such requirements as the Secretary may prescribe by regulations to prevent the avoidance of the purposes of this paragraph.

Not more than 30 days during any calendar year may be disregarded under this subparagraph.

(B) INDIVIDUALS WITH TIES TO OTHER COUNTRIES.—An individual is described in this subparagraph if—

(i) the individual becomes (not later than the close of a reasonable period after loss of United States citizenship or termination of residency) a citizen or resident of the country in which—

(I) such individual was born,

(II) if such individual is married, such individual's spouse was born, or

(III) either of such individual's parents were born, and

(ii) the individual becomes fully liable for income tax in such country.

(C) MINIMAL PRIOR PHYSICAL PRESENCE IN THE UNITED STATES.—An individual is described in this subparagraph if, for each year in the 10-year period ending on the date of loss of United States citizenship or termination of residency, the individual was physically present in the United States for 30 days or less. The rule of section 7701(b)(3)(D)(ii) shall apply for purposes of this subparagraph.

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Subpart B—Foreign Corporations

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SEC. 881. TAX ON INCOME OF FOREIGN CORPORATIONS NOT CONNECTED WITH UNITED STATES BUSINESS.

(a) * * *

* * * * * * *

(e) TAX NOT TO APPLY TO CERTAIN DIVIDENDS OF REGULATED INVESTMENT COMPANIES.—

(1) INTEREST-RELATED DIVIDENDS.—

(A) IN GENERAL.—Except as provided in subparagraph (B), no tax shall be imposed under paragraph (1) of subsection (a) on any interest-related dividend (as defined in section 871(k)(1)) received from a regulated investment company.

(B) EXCEPTION.—Subparagraph (A) shall not apply—

(i) to any dividend referred to in section 871(k)(1)(B), and

(ii) to any interest-related dividend received by a controlled foreign corporation (within the meaning of section 957(a)) to the extent such dividend is attributable to interest received by the regulated investment company from a person who is a related person (within the meaning of section 864(d)(4)) with respect to such controlled foreign corporation.

(C) TREATMENT OF DIVIDENDS RECEIVED BY CONTROLLED FOREIGN CORPORATIONS.—The rules of subsection (c)(5)(A) shall apply to any interest-related dividend received by a controlled foreign corporation (within the meaning of sec-

tion 957(a)) to the extent such dividend is attributable to interest received by the regulated investment company which is described in clause (ii) of section 871(k)(1)(E) (and not described in clause (i) or (iii) of such section).

(2) SHORT-TERM CAPITAL GAIN DIVIDENDS.—No tax shall be imposed under paragraph (1) of subsection (a) on any short-term capital gain dividend (as defined in section 871(k)(2)) received from a regulated investment company.

[(e)] *(f)* CROSS REFERENCE.—

For doubling of tax on corporations of certain foreign countries, see section 891.

For special rules for original issue discount, see section 871(g).

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Subpart D—Miscellaneous Provisions

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SEC. 897. DISPOSITION OF INVESTMENT IN UNITED STATES REAL PROPERTY.

(a) * * *

* * * * * * *

(h) SPECIAL RULES FOR [REITS] *CERTAIN INVESTMENT ENTITIES*.—For purposes of this section—

(1) LOOK-THROUGH OF DISTRIBUTIONS.—Any distribution by a [REIT] *qualified investment entity* to a nonresident alien individual or a foreign corporation shall, to the extent attributable to gain from sales or exchanges by the [REIT] *qualified investment entity* of United States real property interests, be treated as gain recognized by such nonresident alien individual or foreign corporation from the sale or exchange of a United States real property interest.

[(2) SALE OF STOCK IN DOMESTICALLY-CONTROLLED REIT NOT TAXED.—The term "United States real property interest" does not include any interest in a domestically-controlled REIT.

[(3) DISTRIBUTIONS BY DOMESTICALLY-CONTROLLED REITS.—In the case of a domestically-controlled REIT, rules similar to the rules of subsection (d) shall apply to the foreign ownership percentage of any gain.]

(2) SALE OF STOCK IN DOMESTICALLY CONTROLLED ENTITY NOT TAXED.—The term "United States real property interest" does not include any interest in a domestically controlled qualified investment entity.

(3) DISTRIBUTIONS BY DOMESTICALLY CONTROLLED QUALIFIED INVESTMENT ENTITIES.—In the case of a domestically controlled qualified investment entity, rules similar to the rules of subsection (d) shall apply to the foreign ownership percentage of any gain.

(4) DEFINITIONS.—

[(A) REIT.—The term "REIT" means a real estate investment trust.

[(B) DOMESTICALLY-CONTROLLED REIT.—The term "domestically-controlled REIT" means a REIT in which at all times during the testing period less than 50 percent in value of the stock was held directly or indirectly by foreign persons.]

(A) QUALIFIED INVESTMENT ENTITY.—The term “qualified investment entity” means any real estate investment trust and any regulated investment company.

(B) DOMESTICALLY CONTROLLED.—The term “domestically controlled qualified investment entity” means any qualified investment entity in which at all times during the testing period less than 50 percent in value of the stock was held directly or indirectly by foreign persons.

(C) FOREIGN OWNERSHIP PERCENTAGE.—The term “foreign ownership percentage” means that percentage of the stock of the [REIT] *qualified investment entity* which was held (directly or indirectly) by foreign persons at the time during the testing period during which the direct and indirect ownership of stock by foreign persons was greatest.

(D) TESTING PERIOD.—The term “testing period” means whichever of the following periods is the shortest:

(i) * * *

* * * * * * *

(iii) the period during which the [REIT] *qualified investment entity* was in existence.

* * * * * * *

SEC. 898. TAXABLE YEAR OF CERTAIN FOREIGN CORPORATIONS.

(a) * * *

(b) SPECIFIED FOREIGN CORPORATION.—For purposes of this section—

(1) IN GENERAL.—The term “specified foreign corporation” means any foreign corporation—

[(A) which is—

[(i) treated as a controlled foreign corporation for any purpose under subpart F of part III of this subchapter, or

[(ii) a foreign personal holding company (as defined in section 552), and]

(A) which is treated as a controlled foreign corporation for any purpose under subpart F of part III of this subchapter, and

* * * * * * *

(2) OWNERSHIP REQUIREMENTS.—

(A) * * *

(B) OWNERSHIP.—For purposes of subparagraph (A), the rules of subsections (a) and (b) of section 958 [and sections 551(f) and 554, whichever are applicable,] shall apply in determining ownership.

[(3) UNITED STATES SHAREHOLDER.—

[(A) IN GENERAL.—The term “United States shareholder” has the meaning given to such term by section 951(b), except that, in the case of a foreign corporation having related person insurance income (as defined in section 953(c)(2)), the Secretary may treat any person as a United States shareholder for purposes of this section if such person is treated as a United States shareholder under section 953(c)(1).

⟦(B) FOREIGN PERSONAL HOLDING COMPANIES.—In the case of any foreign personal holding company (as defined in section 552) which is not a specified foreign corporation by reason of paragraph (1)(A)(i), the term "United States shareholder" means any person who is treated as a United States shareholder under section 551.⟧

(3) UNITED STATES SHAREHOLDER.—The term "United States shareholder" has the meaning given to such term by section 951(b), except that, in the case of a foreign corporation having related person insurance income (as defined in section 953(c)(2)), the Secretary may treat any person as a United States shareholder for purposes of this section if such person is treated as a United States shareholder under section 953(c)(1).

⟦(c) DETERMINATION OF REQUIRED YEAR.—

⟦(1) CONTROLLED FOREIGN CORPORATIONS.—

⟦(A) IN GENERAL.—In the case of a specified foreign corporation described in subsection (b)(1)(A)(i), the required year is—

⟦(i) the majority U.S. shareholder year, or

⟦(ii) if there is no majority U.S. shareholder year, the taxable year prescribed under regulations.

⟦(B) 1-MONTH DEFERRAL ALLOWED.—A specified foreign corporation may elect, in lieu of the taxable year under subparagraph (A)(i), a taxable year beginning 1 month earlier than the majority U.S. shareholder year.

⟦(C) MAJORITY U.S. SHAREHOLDER YEAR.—

⟦(i) IN GENERAL.—For purposes of this subsection, the term "majority U.S. shareholder year" means the taxable year (if any) which, on each testing day, constituted the taxable year of—

⟦(I) each United States shareholder described in subsection (b)(2)(A), and

⟦(II) each United States shareholder not described in subclause (I) whose stock was treated as owned under subsection (b)(2)(B) by any shareholder described in such subclause.

⟦(ii) TESTING DAY.—The testing days shall be—

⟦(I) the first day of the corporation's taxable year (determined without regard to this section), or

⟦(II) the days during such representative period as the Secretary may prescribe.

⟦(2) FOREIGN PERSONAL HOLDING COMPANIES.—In the case of a foreign personal holding company described in subsection (b)(3)(B), the required year shall be determined under paragraph (1), except that subparagraph (B) of paragraph (1) shall not apply.⟧

(c) DETERMINATION OF REQUIRED YEAR.—

(1) IN GENERAL.—The required year is—

(A) the majority U.S. shareholder year, or

(B) if there is no majority U.S. shareholder year, the taxable year prescribed under regulations.

(2) 1-MONTH DEFERRAL ALLOWED.—A specified foreign corporation may elect, in lieu of the taxable year under paragraph

(1)(A), a taxable year beginning 1 month earlier than the majority U.S. shareholder year.

(3) MAJORITY U.S. SHAREHOLDER YEAR.—

(A) IN GENERAL.—For purposes of this subsection, the term "majority U.S. shareholder year" means the taxable year (if any) which, on each testing day, constituted the taxable year of—

(i) each United States shareholder described in subsection (b)(2)(A), and

(ii) each United States shareholder not described in clause (i) whose stock was treated as owned under subsection (b)(2)(B) by any shareholder described in such clause.

(B) TESTING DAY.—The testing days shall be—

(i) the first day of the corporation's taxable year (determined without regard to this section), or

(ii) the days during such representative period as the Secretary may prescribe.

* * * * * * *

PART III—INCOME FROM SOURCES WITHOUT THE UNITED STATES

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Subpart A—Foreign Tax Credit

* * * * * * *

SEC. 901. TAXES OF FOREIGN COUNTRIES AND OF POSSESSIONS OF UNITED STATES.

(a) * * *

(b) AMOUNT ALLOWED.—Subject to the limitation of section 904, the following amounts shall be allowed as the credit under subsection (a):

(1) * * *

* * * * * * *

(5) PARTNERSHIPS AND ESTATES.—In the case of [any individual] *any person* described in paragraph (1), (2), (3), or (4), who is a member of a partnership or a beneficiary of an estate or trust, the amount of his proportionate share of the taxes (described in such paragraph) of the partnership or the estate or trust paid or accrued during the taxable year to a foreign country or to any possession of the United States, as the case may be. Under rules or regulations prescribed by the Secretary, in the case of any foreign trust of which the settlor or another person would be treated as owner of any portion of the trust under subpart E but for section 672(f), the allocable amount of any income, war profits, and excess profits taxes imposed by any foreign country or possession of the United States on the settlor or such other person in respect of trust income.

* * * * * * *

(k) MINIMUM HOLDING PERIOD FOR CERTAIN TAXES *ON DIVIDENDS*.—

(1) * * *

* * * * * * *

(l) MINIMUM HOLDING PERIOD FOR WITHHOLDING TAXES ON GAIN AND INCOME OTHER THAN DIVIDENDS ETC.—

(1) IN GENERAL.—In no event shall a credit be allowed under subsection (a) for any withholding tax (as defined in subsection (k)) on any item of income or gain with respect to any property if—

(A) such property is held by the recipient of the item for 15 days or less during the 30-day period beginning on the date which is 15 days before the date on which the right to receive payment of such item arises, or

(B) to the extent that the recipient of the item is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

This paragraph shall not apply to any dividend to which subsection (k) applies.

(2) EXCEPTION FOR TAXES PAID BY DEALERS.—

(A) IN GENERAL.—Paragraph (1) shall not apply to any qualified tax with respect to any property held in the active conduct in a foreign country of a business as a dealer in such property.

(B) QUALIFIED TAX.—For purposes of subparagraph (A), the term "qualified tax" means a tax paid to a foreign country (other than the foreign country referred to in subparagraph (A)) if—

(i) the item to which such tax is attributable is subject to taxation on a net basis by the country referred to in subparagraph (A), and

(ii) such country allows a credit against its net basis tax for the full amount of the tax paid to such other foreign country.

(C) DEALER.—For purposes of subparagraph (A), the term "dealer" means—

(i) with respect to a security, any person to whom paragraphs (1) and (2) of subsection (k) would not apply by reason of paragraph (4) thereof if such security were stock, and

(ii) with respect to any other property, any person with respect to whom such property is described in section 1221(a)(1).

(D) REGULATIONS.—The Secretary may prescribe such regulations as may be appropriate to carry out this paragraph, including regulations to prevent the abuse of the exception provided by this paragraph and to treat other taxes as qualified taxes.

(3) EXCEPTIONS.—The Secretary may by regulation provide that paragraph (1) shall not apply to property where the Secretary determines that the application of paragraph (1) to such property is not necessary to carry out the purposes of this subsection.

(4) CERTAIN RULES TO APPLY.—Rules similar to the rules of paragraphs (5), (6), and (7) of subsection (k) shall apply for purposes of this subsection.

(5) DETERMINATION OF HOLDING PERIOD.—Holding periods shall be determined for purposes of this subsection without regard to section 1235 or any similar rule.

[(l)] *(m)* CROSS REFERENCE.—

(1) * * *

* * * * * * *

SEC. 902. DEEMED PAID CREDIT WHERE DOMESTIC CORPORATION OWNS 10 PERCENT OR MORE OF VOTING STOCK OF FOREIGN CORPORATION.

(a) * * *

* * * * * * *

(c) DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

(1) * * *

* * * * * * *

(7) CONSTRUCTIVE OWNERSHIP THROUGH PARTNERSHIPS.—Stock owned, directly or indirectly, by or for a partnership shall be considered as being owned proportionately by its partners. Stock considered to be owned by a person by reason of the preceding sentence shall, for purposes of applying such sentence, be treated as actually owned by such person. The Secretary may prescribe such regulations as may be necessary to carry out the purposes of this paragraph, including rules to account for special partnership allocations of dividends, credits, and other incidents of ownership of stock in determining proportionate ownership.

[(7)] *(8)* REGULATIONS.—The Secretary shall provide such regulations as may be necessary or appropriate to carry out the provisions of this section and section 960, including provisions which provide for the separate application of this section and section 960 to reflect the separate application of section 904 to separate types of income and loss.

* * * * * * *

SEC. 904. LIMITATION ON CREDIT.

(a) * * *

(b) TAXABLE INCOME FOR PURPOSE OF COMPUTING LIMITATION.—

(1) * * *

* * * * * * *

(3) DEFINITIONS.—For purposes of this subsection—

(A) * * *

* * * * * * *

(D) CAPITAL GAIN RATE DIFFERENTIAL.—There is a capital gain rate differential for any taxable year if—

(i) * * *

[(ii) in the case of a corporation, any rate of tax imposed by section 11, 511, or 831(a) or (b) (whichever applies) exceeds the alternative rate of tax under section 1201(a) (determined without regard to the last sentence of section 11(b)(1)).]

(ii) in the case of a corporation, section 1201(a) applies to such taxable year.

* * * * * * *

(d) SEPARATE APPLICATION OF SECTION WITH RESPECT TO CERTAIN CATEGORIES OF INCOME.—

⟦(1) IN GENERAL.—The provisions of subsections (a), (b), and (c) and sections 902, 907, and 960 shall be applied separately with respect to each of the following items of income:

⟦(A) passive income,

⟦(B) high withholding tax interest,

⟦(C) financial services income,

⟦(D) shipping income,

⟦(E) in the case of a corporation, dividends from noncontrolled section 902 corporations out of earnings and profits accumulated in taxable years beginning before January 1, 2003,

⟦(F) dividends from a DISC or former DISC (as defined in section 992(a)) to the extent such dividends are treated as income from sources without the United States,

⟦(G) taxable income attributable to foreign trade income (within the meaning of section 923(b)),

⟦(H) distributions from a FSC (or a former FSC) out of earnings and profits attributable to foreign trade income (within the meaning of section 923(b)) or interest or carrying charges (as defined in section 927(d)(1)) derived from a transaction which results in foreign trade income (as defined in section 923(b)), and

⟦(I) income other than income described in any of the preceding subparagraphs.⟧

(1) IN GENERAL.—The provisions of subsections (a), (b), and (c) and sections 902, 907, and 960 shall be applied separately with respect to—

(A) passive category income, and

(B) general category income.

(2) DEFINITIONS AND SPECIAL RULES.—For purposes of this subsection—

(A) CATEGORIES.—

(i) PASSIVE CATEGORY INCOME.—The term "passive category income" means passive income and specified passive category income.

ii) GENERAL CATEGORY INCOME.—The term "general category income" means income other than passive category income.

⟦(A)⟧ *(B)* PASSIVE INCOME.—

(i) * * *

* * * * * * *

(iii) EXCEPTIONS.—The term "passive income" shall not include—

⟦(I) any income described in a subparagraph of paragraph (1) other than subparagraph (A),⟧

⟦(II)⟧ *(I)* any export financing interest, and

⟦(III)⟧ *(II)* any high-taxed income.

* * * * * * *

(v) SPECIFIED PASSIVE CATEGORY INCOME.—The term "specified passive category income" means—

(I) dividends from a DISC or former DISC (as defined in section 992(a)) to the extent such dividends are treated as income from sources without the United States,

(II) taxable income attributable to foreign trade income (within the meaning of section 923(b)), and

(III) distributions from a FSC (or a former FSC) out of earnings and profits attributable to foreign trade income (within the meaning of section 923(b)) or interest or carrying charges (as defined in section 927(d)(1)) derived from a transaction which results in foreign trade income (as defined in section 923(b)).

⟦(B) HIGH WITHHOLDING TAX INTEREST.—

⟦(i) IN GENERAL.—Except as otherwise provided in this subparagraph, the term "high withholding tax interest" means any interest if—

⟦(I) such interest is subject to a withholding tax of a foreign country or possession of the United States (or other tax determined on a gross basis), and

⟦(II) the rate of such tax applicable to such interest is at least 5 percent.

⟦(ii) EXCEPTION FOR EXPORT FINANCING.—The term "high withholding tax interest" shall not include any export financing interest.

⟦(iii) REGULATIONS.—The Secretary may by regulations provide that—

⟦(I) amounts (not otherwise high withholding tax interest) shall be treated as high withholding tax interest where necessary to prevent avoidance of the purposes of this subparagraph, and

⟦(II) a tax shall not be treated as a withholding tax or other tax imposed on a gross basis if such tax is in the nature of a prepayment of a tax imposed on a net basis.⟧

(C) TREATMENT OF FINANCIAL SERVICES INCOME AND COMPANIES.—

(i) IN GENERAL.—Financial services income shall be treated as general category income in the case of—

(I) a member of a financial services group, and

(II) any other person if such person is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business.

(ii) FINANCIAL SERVICES GROUP.—The term "financial services group" means any affiliated group (as defined in section 1504(a) without regard to paragraphs (2) and (3) of section 1504(b)) which is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business. In determining whether such a group is so engaged, there shall be taken into account only the income of members of the group that are—

(I) United States corporations, or

(II) controlled foreign corporations in which such United States corporations own, directly or indirectly, at least 80 percent of the total voting power and value of the stock.

(iii) PASS-THRU ENTITIES.—The Secretary shall by regulation specify for purposes of this subparagraph the treatment of financial services income received or accrued by partnerships and by other pass-thru entities which are not members of a financial services group.

⟦(C)⟧ *(D)* FINANCIAL SERVICES INCOME.—

(i) IN GENERAL.—Except as otherwise provided in this subparagraph, the term "financial services income" means any income which is received or accrued by any person predominantly engaged in the active conduct of a banking, insurance, financing, or similar business, and which is—

(I) described in clause (ii), *or*

⟦(II) passive income (determined without regard to subclauses (I) and (III) of subparagraph (A)(iii)), or

⟦(III) export financing interest which (but for subparagraph (B)(ii)) would be high withholding tax interest.⟧

(II) passive income (determined without regard to subparagraph (B)(iii)(II)).

* * * * * * *

⟦(iii) EXCEPTIONS.—The term "financial services income" does not include—

⟦(I) any high withholding tax interest,

⟦(II) any dividend from a noncontrolled section 902 corporation out of earnings and profits accumulated in taxable years beginning before January 1, 2003, and

⟦(III) any export financing interest not described in clause (i)(III).

⟦(D) SHIPPING INCOME.—The term "shipping income" means any income received or accrued by any person which is of a kind which would be foreign base company shipping income (as defined in section 954(f)). Such term does not include any dividend from a noncontrolled section 902 corporation out of earnings and profits accumulated in taxable years beginning before January 1, 2003 and does not include any financial services income.⟧

(E) NONCONTROLLED SECTION 902 CORPORATION.—

(i) IN GENERAL.—The term "noncontrolled section 902 corporation" means any foreign corporation with respect to which the taxpayer meets the stock ownership requirements of section 902(a) (or, for purposes of applying paragraph (3) *or (4)*, the requirements of section 902(b)). A controlled foreign corporation shall not be treated as a noncontrolled section 902 corporation with respect to any distribution out of its earnings and profits for periods during which it was a controlled foreign corporation.

⟦(ii) SPECIAL RULE FOR TAXES ON HIGH-WITHHOLDING TAX INTEREST.—If a foreign corporation is a noncontrolled section 902 corporation with respect to the taxpayer, taxes on high withholding tax interest (to the extent imposed at a rate in excess of 5 percent) shall not be treated as foreign taxes for purposes of determining the amount of foreign taxes deemed paid by the taxpayer under section 902.⟧

⟦(iii)⟧ *(ii)* TREATMENT OF INCLUSIONS UNDER SECTION 1293.—If any foreign corporation is a non-controlled section 902 corporation with respect to the taxpayer, any inclusion under section 1293 with respect to such corporation shall be treated as a dividend from such corporation.

⟦(iv) ALL NON-PFICS TREATED AS ONE.—All noncontrolled section 902 corporations which are not passive foreign investment companies (as defined in section 1297) shall be treated as one noncontrolled section 902 corporation for purposes of paragraph (1).⟧

(H) TREATMENT OF INCOME TAX BASE DIFFERENCES.—Tax imposed under the law of a foreign country or possession of the United States on an amount which does not constitute income under United States tax principles shall be treated as imposed on income described in paragraph (1)(B).

⟦(H)⟧ *(I)* RELATED PERSON.—For purposes of this paragraph, the term "related person" has the meaning given such term by section 954(d)(3), except that such section shall be applied by substituting "the person with respect to whom the determination is being made" for "controlled foreign corporation" each place it appears.

⟦(I)⟧ *(J)* TRANSITIONAL RULE.—For purposes of paragraph (1)—

(i) * * *

* * * * * * *

(K) TRANSITIONAL RULES FOR 2005 CHANGES.—For purposes of paragraph (1)—

(i) taxes carried from any taxable year beginning before January 1, 2005, to any taxable year beginning on or after such date, with respect to any item of income, shall be treated as described in the subparagraph of paragraph (1) in which such income would be described were such taxes paid or accrued in a taxable year beginning on or after such date, and

(ii) the Secretary may by regulations provide for the allocation of any carryback of taxes with respect to income to such a taxable year for purposes of allocating such income among the separate categories in effect for such taxable year.

[Note: The amendment made by section 1074(c)(14) of H.R. 2896 to section 904(d)(2)(A) (shown below) applies to taxable years of foreign corporations beginning after December 31, 2006, and to taxable years of United States shareholders with or within which such taxable years of foreign corporations end.]

SEC. 904. LIMITATION ON CREDIT.

(a) * * *

* * * * * * *

(d) SEPARATE APPLICATION OF SECTION WITH RESPECT TO CERTAIN CATEGORIES OF INCOME.—

(1) * * *

(2) DEFINITIONS AND SPECIAL RULES.—For purposes of this subsection—

(A) CATEGORIES.—

(i) PASSIVE CATEGORY INCOME.—The term "passive category income" means passive income and specified passive category income.

(ii) CERTAIN AMOUNTS INCLUDED.—Except as provided in clause (iii), the term "passive income" includes, except as provided in subparagraph (E)(iii) or paragraph (3)(I), any amount includible in gross income under section 1293 (relating to certain passive foreign investment companies).

[(3) LOOK-THRU IN CASE OF CONTROLLED FOREIGN CORPORATIONS.—

[(A) IN GENERAL.—Except as otherwise provided in this paragraph, dividends, interest, rents, and royalties received or accrued by the taxpayer from a controlled foreign corporation in which the taxpayer is a United States shareholder shall not be treated as income in a separate category.

[(B) SUBPART F INCLUSIONS.—Any amount included in gross income under section 951(a)(1)(A) shall be treated as income in a separate category to the extent the amount so included is attributable to income in such category.

[(C) INTEREST, RENTS, AND ROYALTIES.—Any interest, rent, or royalty which is received or accrued from a controlled foreign corporation in which the taxpayer is a United States shareholder shall be treated as income in a separate category to the extent it is properly allocable (under regulations prescribed by the Secretary) to income of the controlled foreign corporation in such category.

[(D) DIVIDENDS.—Any dividend paid out of the earnings and profits of any controlled foreign corporation in which the taxpayer is a United States shareholder shall be treated as income in a separate category in proportion to the ratio of—

[(i) the portion of the earnings and profits attributable to income in such category, to

[(ii) the total amount of earnings and profits.

[(E) LOOK-THRU APPLIES ONLY WHERE SUBPART F APPLIES.—If a controlled foreign corporation meets the requirements of section 954(b)(3)(A) (relating to de minimis rule) for any taxable year, for purposes of this paragraph, none of its foreign base company income (as defined in section 954(a) without regard to section 954(b)(5)) and none of its gross insurance income (as defined in section 954(b)(3)(C)) for such taxable year shall be treated as income in a separate category, except that this sentence shall not apply to any income which (without regard to this sentence) would be treated as financial services income. Solely for purposes of applying subparagraph (D), passive income of a controlled foreign corporation shall not be treated as income in a separate category if the requirements of section 954(b)(4) are met with respect to such income.

⟦(F) SEPARATE CATEGORY.—For purposes of this paragraph—

⟦(i) IN GENERAL.—Except as provided in clause (ii), the term "separate category" means any category of income described in subparagraph (A), (B), (C), (D), or (E) of paragraph (1).

⟦(ii) COORDINATION WITH HIGH-TAXED INCOME PROVISIONS.—

⟦(I) In determining whether any income of a controlled foreign corporation is in a separate category, subclause (III) of paragraph (2)(A)(iii) shall not apply.

⟦(II) Any income of the taxpayer which is treated as income in a separate category under this paragraph shall be so treated notwithstanding any provision of paragraph (2); except that the determination of whether any amount is high-taxed income shall be made after the application of this paragraph.

⟦(G) DIVIDEND.—For purposes of this paragraph, the term "dividend" includes any amount included in gross income in section 951(a)(1)(B). Any amount included in gross income under section 78 to the extent attributable to amounts included in gross income in section 951(a)(1)(A) shall not be treated as a dividend but shall be treated as included in gross income under section 951(a)(1)(A).

⟦(H) EXCEPTION FOR CERTAIN HIGH WITHHOLDING TAX INTEREST.—This paragraph shall not apply to any amount which—

⟦(i) without regard to this paragraph, is high withholding tax interest (including any amount treated as high withholding tax interest under paragraph (2)(B)(iii)), and

⟦(ii) would (but for this subparagraph) be treated as financial services income under this paragraph.

The amount to which this paragraph does not apply by reason of the preceding sentence shall not exceed the interest or equivalent income of the controlled foreign corporation taken into account in determining financial services income without regard to this subparagraph.

⟦(I) LOOK-THRU APPLIES TO PASSIVE FOREIGN INVESTMENT COMPANY INCLUSION.—If—

⟦(i) a passive foreign investment company is a controlled foreign corporation, and

⟦(ii) the taxpayer is a United States shareholder in such controlled foreign corporation,any amount included in gross income under section 1293 shall be treated as income in a separate category to the extent such amount is attributable to income in such category.

⟦(4) LOOK-THRU APPLIES TO DIVIDENDS FROM NONCONTROLLED SECTION 902 CORPORATIONS.—

⟦(A) IN GENERAL.—For purposes of this subsection, any applicable dividend shall be treated as income in a separate category in proportion to the ratio of—

⟦(i) the portion of the earnings and profits described in subparagraph (B)(ii) attributable to income in such category, to

⟦(ii) the total amount of such earnings and profits.

⟦(B) APPLICABLE DIVIDEND.—For purposes of subparagraph (A), the term "applicable dividend" means any dividend—

⟦(i) from a noncontrolled section 902 corporation with respect to the taxpayer, and

⟦(ii) paid out of earnings and profits accumulated in taxable years beginning after December 31, 2002.

⟦(C) SPECIAL RULES.—

⟦(i) IN GENERAL.—Rules similar to the rules of paragraph (3)(F) shall apply for purposes of this paragraph.

⟦(ii) EARNINGS AND PROFITS.—For purposes of this paragraph and paragraph (1)(E)—

⟦(I) IN GENERAL.—The rules of section 316 shall apply.

⟦(II) REGULATIONS.—The Secretary may prescribe regulations regarding the treatment of distributions out of earnings and profits for periods prior to the taxpayer's acquisition of such stock.⟧

(3) LOOK-THRU IN CASE OF CONTROLLED FOREIGN CORPORATIONS.—

(A) IN GENERAL.—Except as otherwise provided in this paragraph, dividends, interest, rents, and royalties received or accrued by the taxpayer from a controlled foreign corporation in which the taxpayer is a United States shareholder shall not be treated as passive category income.

(B) SUBPART F INCLUSIONS.—Any amount included in gross income under section 951(a)(1)(A) shall be treated as passive category income to the extent the amount so included is attributable to passive category income.

(C) INTEREST, RENTS, AND ROYALTIES.—Any interest, rent, or royalty which is received or accrued from a controlled foreign corporation in which the taxpayer is a United States shareholder shall be treated as passive category income to the extent it is properly allocable (under regulations prescribed by the Secretary) to passive category income of the controlled foreign corporation.

(D) DIVIDENDS.—Any dividend paid out of the earnings and profits of any controlled foreign corporation in which

the taxpayer is a United States shareholder shall be treated as passive category income in proportion to the ratio of—

(i) the portion of the earnings and profits attributable to passive category income, to

(ii) the total amount of earnings and profits.

(E) LOOK-THRU APPLIES ONLY WHERE SUBPART F APPLIES.—If a controlled foreign corporation meets the requirements of section 954(b)(3)(A) (relating to de minimis rule) for any taxable year, for purposes of this paragraph, none of its foreign base company income (as defined in section 954(a) without regard to section 954(b)(5)) and none of its gross insurance income (as defined in section 954(b)(3)(C)) for such taxable year shall be treated as passive category income, except that this sentence shall not apply to any income which (without regard to this sentence) would be treated as financial services income. Solely for purposes of applying subparagraph (D), passive income of a controlled foreign corporation shall not be treated as passive category income if the requirements of section 954(b)(4) are met with respect to such income.

(F) COORDINATION WITH HIGH-TAXED INCOME PROVISIONS.—

(i) In determining whether any income of a controlled foreign corporation is passive category income, subclause (II) of paragraph (2)(B)(iii) shall not apply.

(ii) Any income of the taxpayer which is treated as passive category income under this paragraph shall be so treated notwithstanding any provision of paragraph (2); except that the determination of whether any amount is high-taxed income shall be made after the application of this paragraph.

(G) DIVIDEND.—For purposes of this paragraph, the term "dividend" includes any amount included in gross income in section 951(a)(1)(B). Any amount included in gross income under section 78 to the extent attributable to amounts included in gross income in section 951(a)(1)(A) shall not be treated as a dividend but shall be treated as included in gross income under section 951(a)(1)(A).

(H) LOOK-THRU APPLIES TO PASSIVE FOREIGN INVESTMENT COMPANY INCLUSION.—If—

(i) a passive foreign investment company is a controlled foreign corporation, and

(ii) the taxpayer is a United States shareholder in such controlled foreign corporation,

any amount included in gross income under section 1293 shall be treated as income in a separate category to the extent such amount is attributable to income in such category.

(4) LOOK-THRU APPLIES TO DIVIDENDS FROM NONCONTROLLED SECTION 902 CORPORATIONS.—

(A) IN GENERAL.—For purposes of this subsection, any dividend from a noncontrolled section 902 corporation with respect to the taxpayer shall be treated as income described in a subparagraph of paragraph (1) in proportion to the ratio of—

(i) the portion of earnings and profits attributable to income described in such subparagraph, to

(ii) the total amount of earnings and profits.

(B) SPECIAL RULES.—For purposes of this paragraph—

(i) EARNINGS AND PROFITS.—

(I) IN GENERAL.—The rules of section 316 shall apply.

(II) REGULATIONS.—The Secretary may prescribe regulations regarding the treatment of distributions out of earnings and profits for periods before the taxpayer's acquisition of the stock to which the distributions relate.

(ii) INADEQUATE SUBSTANTIATION.—If the Secretary determines that the proper subparagraph of paragraph (1) in which a dividend is described has not been substantiated, such dividend shall be treated as income described in paragraph (1)(A).

(iii) LOOK-THRU WITH RESPECT TO CARRYFORWARDS OF CREDIT.—Rules similar to subparagraph (A) also shall apply to any carryforward under subsection (c) from a taxable year beginning before January 1, 2003, of tax allocable to a dividend from a noncontrolled section 902 corporation with respect to the taxpayer. The Secretary may by regulations provide for the allocation of any carryback of tax allocable to a dividend from a noncontrolled section 902 corporation to such a taxable year for purposes of allocating such dividend among the separate categories in effect for such taxable year.

(iv) COORDINATION WITH HIGH-TAXED INCOME PROVISIONS.—Rules similar to the rules of paragraph (3)(F) shall apply for purposes of this paragraph.

(g) RECHARACTERIZATION OF OVERALL DOMESTIC LOSS.—

(1) GENERAL RULE.—For purposes of this subpart and section 936, in the case of any taxpayer who sustains an overall domestic loss for any taxable year beginning after December 31, 2005, that portion of the taxpayer's taxable income from sources within the United States for each succeeding taxable year which is equal to the lesser of—

(A) the amount of such loss (to the extent not used under this paragraph in prior taxable years), or

(B) 50 percent of the taxpayer's taxable income from sources within the United States for such succeeding taxable year,

shall be treated as income from sources without the United States (and not as income from sources within the United States).

(2) OVERALL DOMESTIC LOSS DEFINED.—For purposes of this subsection—

(A) IN GENERAL.—The term "overall domestic loss" means any domestic loss to the extent such loss offsets taxable income from sources without the United States for the taxable year or for any preceding taxable year by reason of a carryback. For purposes of the preceding sentence, the term "domestic loss" means the amount by which the gross income for the taxable year from sources within the United

States is exceeded by the sum of the deductions properly apportioned or allocated thereto (determined without regard to any carryback from a subsequent taxable year).

(B) TAXPAYER MUST HAVE ELECTED FOREIGN TAX CREDIT FOR YEAR OF LOSS.—The term "overall domestic loss" shall not include any loss for any taxable year unless the taxpayer chose the benefits of this subpart for such taxable year.

(3) CHARACTERIZATION OF SUBSEQUENT INCOME.—

(A) IN GENERAL.—Any income from sources within the United States that is treated as income from sources without the United States under paragraph (1) shall be allocated among and increase the income categories in proportion to the loss from sources within the United States previously allocated to those income categories.

(B) INCOME CATEGORY.—For purposes of this paragraph, the term "income category" has the meaning given such term by subsection (f)(5)(E)(i).

(4) COORDINATION WITH SUBSECTION (f).—The Secretary shall prescribe such regulations as may be necessary to coordinate the provisions of this subsection with the provisions of subsection (f).

【(g)】 *(h)* SOURCE RULES IN CASE OF UNITED STATES-OWNED FOREIGN CORPORATIONS.—

(1) IN GENERAL.—The following amounts which are derived from a United States-owned foreign corporation and which would be treated as derived from sources outside the United States without regard to this subsection shall, for purposes of this section, be treated as derived from sources within the United States to the extent provided in this subsection:

(A) Any amount included in gross income under—

(i) section 951(a) (relating to amounts included in gross income of United States shareholders), *or*

【(ii) section 551 (relating to foreign personal holding company income taxed to United States shareholders), or】

【(iii)】 *(ii)* section 1293 (relating to current taxation of income from qualified funds).

* * * * * * *

(2) SUBPART F AND 【FOREIGN PERSONAL HOLDING OR】 PASSIVE FOREIGN INVESTMENT COMPANY INCLUSIONS.—Any amount described in subparagraph (A) of paragraph (1) shall be treated as derived from sources within the United States to the extent such amount is attributable to income of the United States-owned foreign corporation from sources within the United States.

【(h)】 *(i)* COORDINATION WITH NONREFUNDABLE PERSONAL CREDITS.—In the case of an individual, for purposes of subsection (a), the tax against which the credit is taken is such tax reduced by the sum of the credits allowable under subpart A of part IV of subchapter A of this chapter. This subsection shall not apply to taxable years beginning during 2000, 2001, 2002, or 2003.

【(i)】 *(j)* LIMITATION ON USE OF DECONSOLIDATION TO AVOID FOREIGN TAX CREDIT LIMITATIONS.—If 2 or more domestic corporations would be members of the same affiliated group if—

(1) * * *

*   *   *   *   *   *   *

⟦(j)⟧ *(k)* CERTAIN INDIVIDUALS EXEMPT.—

(1) * * *

*   *   *   *   *   *   *

(3) DEFINITIONS.—For purposes of this subsection—

(A) QUALIFIED PASSIVE INCOME.—The term "qualified passive income" means any item of gross income if—

(i) such item of income is passive income (as defined in ⟦subsection (d)(2)(A)⟧ *subsection (d)(2)(B)* without regard to clause (iii) thereof), and

⟦(k)⟧ *(l)* Cross references

(1) * * *

*   *   *   *   *   *   *

Subpart D—Possessions of the United States

*   *   *   *   *   *   *

SEC. 936. PUERTO RICO AND POSSESSION TAX CREDIT.

(a) ALLOWANCE OF CREDIT.—

(1) * * *

(2) CONDITIONS WHICH MUST BE SATISFIED.—The conditions referred to in paragraph (1) are:

(A) 3-YEAR PERIOD.—If 80 percent or more of the gross income of such domestic corporation for the 3-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from sources within a possession of the United States (determined without regard to ⟦section 904(f)⟧ *subsections (f) and (g) of section 904*); and

*   *   *   *   *   *   *

⟦Subpart E—Qualifying Foreign Trade Income

⟦SEC. 941. QUALIFYING FOREIGN TRADE INCOME.

⟦(a) QUALIFYING FOREIGN TRADE INCOME.—For purposes of this subpart and section 114—

⟦(1) IN GENERAL.—The term "qualifying foreign trade income" means, with respect to any transaction, the amount of gross income which, if excluded, will result in a reduction of the taxable income of the taxpayer from such transaction equal to the greatest of—

⟦(A) 30 percent of the foreign sale and leasing income derived by the taxpayer from such transaction,

⟦(B) 1.2 percent of the foreign trading gross receipts derived by the taxpayer from the transaction, or

⟦(C) 15 percent of the foreign trade income derived by the taxpayer from the transaction.

In no event shall the amount determined under subparagraph (B) exceed 200 percent of the amount determined under subparagraph (C).

[(2) ALTERNATIVE COMPUTATION.—A taxpayer may compute its qualifying foreign trade income under a subparagraph of paragraph (1) other than the subparagraph which results in the greatest amount of such income.

[(3) LIMITATION ON USE OF FOREIGN TRADING GROSS RECEIPTS METHOD.—If any person computes its qualifying foreign trade income from any transaction with respect to any property under paragraph (1)(B), the qualifying foreign trade income of such person (or any related person) with respect to any other transaction involving such property shall be zero.

[(4) RULES FOR MARGINAL COSTING.—The Secretary shall prescribe regulations setting forth rules for the allocation of expenditures in computing foreign trade income under paragraph (1)(C) in those cases where a taxpayer is seeking to establish or maintain a market for qualifying foreign trade property.

[(5) PARTICIPATION IN INTERNATIONAL BOYCOTTS, ETC.—Under regulations prescribed by the Secretary, the qualifying foreign trade income of a taxpayer for any taxable year shall be reduced (but not below zero) by the sum of—

[(A) an amount equal to such income multiplied by the international boycott factor determined under section 999, and

[(B) any illegal bribe, kickback, or other payment (within the meaning of section 162(c)) paid by or on behalf of the taxpayer directly or indirectly to an official, employee, or agent in fact of a government.

[(b) FOREIGN TRADE INCOME.—For purposes of this subpart—

[(1) IN GENERAL.—The term "foreign trade income" means the taxable income of the taxpayer attributable to foreign trading gross receipts of the taxpayer.

[(2) SPECIAL RULE FOR COOPERATIVES.—In any case in which an organization to which part I of subchapter T applies which is engaged in the marketing of agricultural or horticultural products sells qualifying foreign trade property, in computing the taxable income of such cooperative, there shall not be taken into account any deduction allowable under subsection (b) or (c) of section 1382 (relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions).

[(c) FOREIGN SALE AND LEASING INCOME.—For purposes of this section—

[(1) IN GENERAL.—The term "foreign sale and leasing income" means, with respect to any transaction—

[(A) foreign trade income properly allocable to activities which—

[(i) are described in paragraph (2)(A)(i) or (3) of section 942(b), and

[(ii) are performed by the taxpayer (or any person acting under a contract with such taxpayer) outside the United States, or

[(B) foreign trade income derived by the taxpayer in connection with the lease or rental of qualifying foreign trade property for use by the lessee outside the United States.

⟦(2) SPECIAL RULES FOR LEASED PROPERTY.—

⟦(A) SALES INCOME.—The term "foreign sale and leasing income" includes any foreign trade income derived by the taxpayer from the sale of property described in paragraph (1)(B).

⟦(B) LIMITATION IN CERTAIN CASES.—Except as provided in regulations, in the case of property which—

⟦(i) was manufactured, produced, grown, or extracted by the taxpayer, or

⟦(ii) was acquired by the taxpayer from a related person for a price which was not determined in accordance with the rules of section 482,

the amount of foreign trade income which may be treated as foreign sale and leasing income under paragraph (1)(B) or subparagraph (A) of this paragraph with respect to any transaction involving such property shall not exceed the amount which would have been determined if the taxpayer had acquired such property for the price determined in accordance with the rules of section 482.

⟦(3) SPECIAL RULES.—

⟦(A) EXCLUDED PROPERTY.—Foreign sale and leasing income shall not include any income properly allocable to excluded property described in subparagraph (B) of section 943(a)(3) (relating to intangibles).

⟦(B) ONLY DIRECT EXPENSES TAKEN INTO ACCOUNT.—For purposes of this subsection, any expense other than a directly allocable expense shall not be taken into account in computing foreign trade income.

⟦SEC. 942. FOREIGN TRADING GROSS RECEIPTS.

⟦(a) FOREIGN TRADING GROSS RECEIPTS.—

⟦(1) IN GENERAL.—Except as otherwise provided in this section, for purposes of this subpart, the term "foreign trading gross receipts" means the gross receipts of the taxpayer which are—

⟦(A) from the sale, exchange, or other disposition of qualifying foreign trade property,

⟦(B) from the lease or rental of qualifying foreign trade property for use by the lessee outside the United States,

⟦(C) for services which are related and subsidiary to—

⟦(i) any sale, exchange, or other disposition of qualifying foreign trade property by such taxpayer, or

⟦(ii) any lease or rental of qualifying foreign trade property described in subparagraph (B) by such taxpayer,

⟦(D) for engineering or architectural services for construction projects located (or proposed for location) outside the United States, or

⟦(E) for the performance of managerial services for a person other than a related person in furtherance of the production of foreign trading gross receipts described in subparagraph (A), (B), or (C).

Subparagraph (E) shall not apply to a taxpayer for any taxable year unless at least 50 percent of its foreign trading gross receipts (determined without regard to this sentence) for such taxable year is derived from activities described in subparagraph (A), (B), or (C).

⟦(2) CERTAIN RECEIPTS EXCLUDED ON BASIS OF USE; SUBSIDIZED RECEIPTS EXCLUDED.—The term "foreign trading gross receipts" shall not include receipts of a taxpayer from a transaction if—

⟦(A) the qualifying foreign trade property or services—

⟦(i) are for ultimate use in the United States, or

⟦(ii) are for use by the United States or any instrumentality thereof and such use of qualifying foreign trade property or services is required by law or regulation, or

⟦(B) such transaction is accomplished by a subsidy granted by the government (or any instrumentality thereof) of the country or possession in which the property is manufactured, produced, grown, or extracted.

⟦(3) ELECTION TO EXCLUDE CERTAIN RECEIPTS.—The term "foreign trading gross receipts" shall not include gross receipts of a taxpayer from a transaction if the taxpayer elects not to have such receipts taken into account for purposes of this subpart.

⟦(b) FOREIGN ECONOMIC PROCESS REQUIREMENTS.—

⟦(1) IN GENERAL.—Except as provided in subsection (c), a taxpayer shall be treated as having foreign trading gross receipts from any transaction only if economic processes with respect to such transaction take place outside the United States as required by paragraph (2).

⟦(2) REQUIREMENT.—

⟦(A) IN GENERAL.—The requirements of this paragraph are met with respect to the gross receipts of a taxpayer derived from any transaction if—

⟦(i) such taxpayer (or any person acting under a contract with such taxpayer) has participated outside the United States in the solicitation (other than advertising), the negotiation, or the making of the contract relating to such transaction, and

⟦(ii) the foreign direct costs incurred by the taxpayer attributable to the transaction equal or exceed 50 percent of the total direct costs attributable to the transaction.

⟦(B) ALTERNATIVE 85-PERCENT TEST.—A taxpayer shall be treated as satisfying the requirements of subparagraph (A)(ii) with respect to any transaction if, with respect to each of at least two subparagraphs of paragraph (3), the foreign direct costs incurred by such taxpayer attributable to activities described in such subparagraph equal or exceed 85 percent of the total direct costs attributable to activities described in such subparagraph.

⟦(C) DEFINITIONS.—For purposes of this paragraph—

⟦(i) TOTAL DIRECT COSTS.—The term "total direct costs" means, with respect to any transaction, the total direct costs incurred by the taxpayer attributable to activities described in paragraph (3) performed at any location by the taxpayer or any person acting under a contract with such taxpayer.

⟦(ii) FOREIGN DIRECT COSTS.—The term "foreign direct costs" means, with respect to any transaction, the portion of the total direct costs which are attributable to activities performed outside the United States.

⟦(3) ACTIVITIES RELATING TO QUALIFYING FOREIGN TRADE PROPERTY.—The activities described in this paragraph are any of the following with respect to qualifying foreign trade property—

⟦(A) advertising and sales promotion,

⟦(B) the processing of customer orders and the arranging for delivery,

⟦(C) transportation outside the United States in connection with delivery to the customer,

⟦(D) the determination and transmittal of a final invoice or statement of account or the receipt of payment, and

⟦(E) the assumption of credit risk.

⟦(4) ECONOMIC PROCESSES PERFORMED BY RELATED PERSONS.—A taxpayer shall be treated as meeting the requirements of this subsection with respect to any sales transaction involving any property if any related person has met such requirements in such transaction or any other sales transaction involving such property.

⟦(c) EXCEPTION FROM FOREIGN ECONOMIC PROCESS REQUIREMENT.—

⟦(1) IN GENERAL.—The requirements of subsection (b) shall be treated as met for any taxable year if the foreign trading gross receipts of the taxpayer for such year do not exceed $5,000,000.

⟦(2) RECEIPTS OF RELATED PERSONS AGGREGATED.—All related persons shall be treated as one person for purposes of paragraph (1), and the limitation under paragraph (1) shall be allocated among such persons in a manner provided in regulations prescribed by the Secretary.

⟦(3) SPECIAL RULE FOR PASS-THRU ENTITIES.—In the case of a partnership, S corporation, or other pass-thru entity, the limitation under paragraph (1) shall apply with respect to the partnership, S corporation, or entity and with respect to each partner, shareholder, or other owner.

⟦SEC. 943. OTHER DEFINITIONS AND SPECIAL RULES.

⟦(a) QUALIFYING FOREIGN TRADE PROPERTY.—For purposes of this subpart—

⟦(1) IN GENERAL.—The term "qualifying foreign trade property" means property—

⟦(A) manufactured, produced, grown, or extracted within or outside the United States,

⟦(B) held primarily for sale, lease, or rental, in the ordinary course of trade or business for direct use, consumption, or disposition outside the United States, and

⟦(C) not more than 50 percent of the fair market value of which is attributable to—

⟦(i) articles manufactured, produced, grown, or extracted outside the United States, and

⟦(ii) direct costs for labor (determined under the principles of section 263A) performed outside the United States.

For purposes of subparagraph (C), the fair market value of any article imported into the United States shall be its appraised value, as determined by the Secretary under section 402 of the Tariff Act of 1930 (19 U.S.C. 1401a) in connection with its importation, and the direct costs for labor under clause (ii) do not include costs that would be treated under the principles of section 263A as direct labor costs attributable to articles described in clause (i).

⟦(2) U.S. TAXATION TO ENSURE CONSISTENT TREATMENT.—Property which (without regard to this paragraph) is qualifying foreign trade property and which is manufactured, produced, grown, or extracted outside the United States shall be treated as qualifying foreign trade property only if it is manufactured, produced, grown, or extracted by—

⟦(A) a domestic corporation,

⟦(B) an individual who is a citizen or resident of the United States,

⟦(C) a foreign corporation with respect to which an election under subsection (e) (relating to foreign corporations electing to be subject to United States taxation) is in effect, or

⟦(D) a partnership or other pass-thru entity all of the partners or owners of which are described in subparagraph (A), (B), or (C).

Except as otherwise provided by the Secretary, tiered partnerships or pass-thru entities shall be treated as described in subparagraph (D) if each of the partnerships or entities is directly or indirectly wholly owned by persons described in subparagraph (A), (B), or (C).

⟦(3) EXCLUDED PROPERTY.—The term "qualifying foreign trade property" shall not include—

⟦(A) property leased or rented by the taxpayer for use by any related person,

⟦(B) patents, inventions, models, designs, formulas, or processes whether or not patented, copyrights (other than films, tapes, records, or similar reproductions, and other than computer software (whether or not patented), for commercial or home use), goodwill, trademarks, trade brands, franchises, or other like property,

⟦(C) oil or gas (or any primary product thereof),

⟦(D) products the transfer of which is prohibited or curtailed to effectuate the policy set forth in paragraph (2)(C) of section 3 of Public Law 96-72, or

⟦(E) any unprocessed timber which is a softwood.

For purposes of subparagraph (E), the term "unprocessed timber" means any log, cant, or similar form of timber.

⟦(4) PROPERTY IN SHORT SUPPLY.—If the President determines that the supply of any property described in paragraph (1) is insufficient to meet the requirements of the domestic economy, the President may by Executive order designate the property as in short supply. Any property so designated shall not be treated as qualifying foreign trade property during the period beginning with the date specified in the Executive order and ending with the date specified in an Executive order setting forth the President's determination that the property is no longer in short supply.

❲(b) OTHER DEFINITIONS AND RULES.—For purposes of this subpart—

❲(1) TRANSACTION.—

❲(A) IN GENERAL.—The term "transaction" means—

❲(i) any sale, exchange, or other disposition,

❲(ii) any lease or rental, and

❲(iii) any furnishing of services.

❲(B) GROUPING OF TRANSACTIONS.—To the extent provided in regulations, any provision of this subpart which, but for this subparagraph, would be applied on a transaction-by-transaction basis may be applied by the taxpayer on the basis of groups of transactions based on product lines or recognized industry or trade usage. Such regulations may permit different groupings for different purposes.

❲(2) UNITED STATES DEFINED.—The term "United States" includes the Commonwealth of Puerto Rico. The preceding sentence shall not apply for purposes of determining whether a corporation is a domestic corporation.

❲(3) RELATED PERSON.—A person shall be related to another person if such persons are treated as a single employer under subsection (a) or (b) of section 52 or subsection (m) or (o) of section 414, except that determinations under subsections (a) and (b) of section 52 shall be made without regard to section 1563(b).

❲(4) GROSS AND TAXABLE INCOME.—Section 114 shall not be taken into account in determining the amount of gross income or foreign trade income from any transaction.

❲(c) SOURCE RULE.—Under regulations, in the case of qualifying foreign trade property manufactured, produced, grown, or extracted within the United States, the amount of income of a taxpayer from any sales transaction with respect to such property which is treated as from sources without the United States shall not exceed—

❲(1) in the case of a taxpayer computing its qualifying foreign trade income under section 941(a)(1)(B), the amount of the taxpayer's foreign trade income which would (but for this subsection) be treated as from sources without the United States if the foreign trade income were reduced by an amount equal to 4 percent of the foreign trading gross receipts with respect to the transaction, and

❲(2) in the case of a taxpayer computing its qualifying foreign trade income under section 941(a)(1)(C), 50 percent of the amount of the taxpayer's foreign trade income which would (but for this subsection) be treated as from sources without the United States.

❲(d) TREATMENT OF WITHHOLDING TAXES.—

❲(1) IN GENERAL.—For purposes of section 114(d), any withholding tax shall not be treated as paid or accrued with respect to extraterritorial income which is excluded from gross income under section 114(a). For purposes of this paragraph, the term "withholding tax" means any tax which is imposed on a basis other than residence and for which credit is allowable under section 901 or 903.

[(2) EXCEPTION.—Paragraph (1) shall not apply to any taxpayer with respect to extraterritorial income from any transaction if the taxpayer computes its qualifying foreign trade income with respect to the transaction under section 941(a)(1)(A).

[(e) ELECTION TO BE TREATED AS DOMESTIC CORPORATION.—

[(1) IN GENERAL.—An applicable foreign corporation may elect to be treated as a domestic corporation for all purposes of this title if such corporation waives all benefits to such corporation granted by the United States under any treaty. No election under section 1362(a) may be made with respect to such corporation.

[(2) APPLICABLE FOREIGN CORPORATION.—For purposes of paragraph (1), the term "applicable foreign corporation" means any foreign corporation if—

[(A) such corporation manufactures, produces, grows, or extracts property in the ordinary course of such corporation's trade or business, or

[(B) substantially all of the gross receipts of such corporation are foreign trading gross receipts.

[(3) PERIOD OF ELECTION.—

[(A) IN GENERAL.—Except as otherwise provided in this paragraph, an election under paragraph (1) shall apply to the taxable year for which made and all subsequent taxable years unless revoked by the taxpayer. Any revocation of such election shall apply to taxable years beginning after such revocation.

[(B) TERMINATION.—If a corporation which made an election under paragraph (1) for any taxable year fails to meet the requirements of subparagraph (A) or (B) of paragraph (2) for any subsequent taxable year, such election shall not apply to any taxable year beginning after such subsequent taxable year.

[(C) EFFECT OF REVOCATION OR TERMINATION.—If a corporation which made an election under paragraph (1) revokes such election or such election is terminated under subparagraph (B), such corporation (and any successor corporation) may not make such election for any of the 5 taxable years beginning with the first taxable year for which such election is not in effect as a result of such revocation or termination.

[(4) SPECIAL RULES.—

[(A) REQUIREMENTS.—This subsection shall not apply to an applicable foreign corporation if such corporation fails to meet the requirements (if any) which the Secretary may prescribe to ensure that the taxes imposed by this chapter on such corporation are paid.

[(B) EFFECT OF ELECTION, REVOCATION, AND TERMINATION.—

[(i) ELECTION.—For purposes of section 367, a foreign corporation making an election under this subsection shall be treated as transferring (as of the first day of the first taxable year to which the election applies) all of its assets to a domestic corporation in connection with an exchange to which section 354 applies.

⟦(ii) REVOCATION AND TERMINATION.—For purposes of section 367, if—

⟦(I) an election is made by a corporation under paragraph (1) for any taxable year, and

⟦(II) such election ceases to apply for any subsequent taxable year,

such corporation shall be treated as a domestic corporation transferring (as of the 1st day of the first such subsequent taxable year to which such election ceases to apply) all of its property to a foreign corporation in connection with an exchange to which section 354 applies.

⟦(C) ELIGIBILITY FOR ELECTION.—The Secretary may by regulation designate one or more classes of corporations which may not make the election under this subsection.

⟦(f) RULES RELATING TO ALLOCATIONS OF QUALIFYING FOREIGN TRADE INCOME FROM SHARED PARTNERSHIPS.—

⟦(1) IN GENERAL.—If—

⟦(A) a partnership maintains a separate account for transactions (to which this subpart applies) with each partner,

⟦(B) distributions to each partner with respect to such transactions are based on the amounts in the separate account maintained with respect to such partner, and

⟦(C) such partnership meets such other requirements as the Secretary may by regulations prescribe,then such partnership shall allocate to each partner items of income, gain, loss, and deduction (including qualifying foreign trade income) from any transaction to which this subpart applies on the basis of such separate account.

⟦(2) SPECIAL RULES.—For purposes of this subpart, in the case of a partnership to which paragraph (1) applies—

⟦(A) any partner's interest in the partnership shall not be taken into account in determining whether such partner is a related person with respect to any other partner, and

⟦(B) the election under section 942(a)(3) shall be made separately by each partner with respect to any transaction for which the partnership maintains separate accounts for each partner.

⟦(g) EXCLUSION FOR PATRONS OF AGRICULTURAL AND HORTICULTURAL COOPERATIVES.—Any amount described in paragraph (1) or (3) of section 1385(a)—

⟦(1) which is received by a person from an organization to which part I of subchapter T applies which is engaged in the marketing of agricultural or horticultural products, and

⟦(2) which is allocable to qualifying foreign trade income and designated as such by the organization in a written notice mailed to its patrons during the payment period described in section 1382(d),shall be treated as qualifying foreign trade income of such person for purposes of section 114. The taxable income of the organization shall not be reduced under section 1382 by reason of any amount to which the preceding sentence applies.

[(h) SPECIAL RULE FOR DISCS.—Section 114 shall not apply to any taxpayer for any taxable year if, at any time during the taxable year, the taxpayer is a member of any controlled group of corporations (as defined in section 927(d)(4), as in effect before the date of the enactment of this subsection) of which a DISC is a member.]

Subpart F—Controlled Foreign Corporations

*   *   *   *   *   *   *

SEC. 951. AMOUNTS INCLUDED IN GROSS INCOME OF UNITED STATES SHAREHOLDERS

(a) * * *

*   *   *   *   *   *   *

[(c) COORDINATION WITH ELECTION OF A FOREIGN INVESTMENT COMPANY TO DISTRIBUTE INCOME.—A United States shareholder who, for his taxable year, is a qualified shareholder (within the meaning of section 1247(c)) of a foreign investment company with respect to which an election under section 1247 is in effect shall not be required to include in gross income, for such taxable year, any amount under subsection (a) with respect to such company.

[(d) COORDINATION WITH FOREIGN PERSONAL HOLDING COMPANY PROVISIONS.—If, but for this subsection, an amount would be included in the gross income of a United States shareholder for any taxable year both under subsection (a)(1)(A)(i) and under section 551(b) (relating to foreign personal holding company income included in gross income of United States shareholder), such amount shall be included in the gross income of such shareholder only under subsection (a)(1)(A).]

[(e)] *(c)* FOREIGN TRADE INCOME NOT TAKEN INTO ACCOUNT.—

(1) * * *

*   *   *   *   *   *   *

[(f)] *(d)* COORDINATION WITH PASSIVE FOREIGN INVESTMENT COMPANY PROVISIONS.—If, but for this subsection, an amount would be included in the gross income of a United States shareholder for any taxable year both under subsection (a)(1)(A)(i) and under section 1293 (relating to current taxation of income from certain passive foreign investment companies), such amount shall be included in the gross income of such shareholder only under subsection (a)(1)(A).

*   *   *   *   *   *   *

SEC. 952. SUBPART F INCOME DEFINED.

(a) * * *

*   *   *   *   *   *   *

(c) LIMITATION.—

(1) IN GENERAL.—

(A) * * *

(B) CERTAIN PRIOR YEAR DEFICITS MAY BE TAKEN INTO ACCOUNT.—

(i) * * *

*   *   *   *   *   *   *

(iii) QUALIFIED ACTIVITY.—For purposes of this paragraph, the term "qualified activity" means any activity giving rise to—

【(I) foreign base company shipping income,】

【(II)】 *(I)* foreign base company oil related income,

【(III)】 *(II)* foreign base company sales income,

【(IV)】 *(III)* foreign base company services income,

【(V)】 *(IV)* in the case of a qualified insurance company, insurance income or foreign personal holding company income, or

【(VI)】 *(V)* in the case of a qualified financial institution, foreign personal holding company income.

* * * * * * *

SEC. 954. FOREIGN BASE COMPANY INCOME.

(a) FOREIGN BASE COMPANY INCOME.—For purposes of section 952(a)(2), the term "foreign base company income" means for any taxable year the sum of—

(1) * * *

* * * * * * *

【(4) the foreign base company shipping income for the taxable year (determined under subsection (f) and reduced as provided in subsection (b)(5)), and】

* * * * * * *

(b) EXCLUSIONS AND SPECIAL RULES.—

(1) * * *

* * * * * * *

(5) DEDUCTIONS TO BE TAKEN INTO ACCOUNT.—For purposes of subsection (a), the foreign personal holding company income, the foreign base company sales income, the foreign base company services income, 【the foreign base company shipping income,】 and the foreign base company oil related income shall be reduced, under regulations prescribed by the Secretary so as to take into account deductions (including taxes) properly allocable to such income. Except to the extent provided in regulations prescribed by the Secretary, any interest which is paid or accrued by the controlled foreign corporation to any United States shareholder in such corporation (or any controlled foreign corporation related to such a shareholder) shall be allocated first to foreign personal holding company income which is passive income (within the meaning of section 904(d)(2) of such corporation to the extent thereof. The Secretary may, by regulations, provide that the preceding sentence shall apply also to interest paid or accrued to other persons.

【(6) SPECIAL RULES FOR FOREIGN BASE COMPANY SHIPPING INCOME.—Income of a corporation which is foreign base company shipping income under paragraph (4) of subsection (a)—

【(A) shall not be considered foreign base company income of such corporation under any other paragraph of subsection (a) and

⟦(B) if distributed through a chain of ownership described under section 958(a), shall not be included in foreign base company income of another controlled foreign corporation in such chain.

⟦(7) SPECIAL EXCLUSION FOR FOREIGN BASE COMPANY SHIPPING INCOME.—Income of a corporation which is foreign base company shipping income under paragraph (4) of subsection (a) shall be excluded from foreign base company income if derived by a controlled foreign corporation from, or in connection with, the use (or hiring or leasing for use) of an aircraft or vessel in foreign commerce between two points within the foreign country in which such corporation is created or organized and such aircraft or vessel is registered.⟧

⟦(8)⟧ *(6)* FOREIGN BASE COMPANY OIL RELATED INCOME NOT TREATED AS ANOTHER KIND OF BASE COMPANY INCOME.—Income of a corporation which is foreign base company oil related income shall not be considered foreign base company income of such corporation under paragraph (2), or (3) of subsection (a).

(c) FOREIGN PERSONAL HOLDING COMPANY INCOME.—

(1) IN GENERAL.—For purposes of subsection (a)(1), the term "foreign personal holding company income" means the portion of the gross income which consists of:

(A) * * *

* * * * * * *

(C) COMMODITIES TRANSACTIONS.—The excess of gains over losses from transactions (including futures, forward, and similar transactions) in any commodities. This subparagraph shall not apply to gains or losses which—

⟦(i) arise out of bona fide hedging transactions reasonably necessary to the conduct of any business by a producer, processor, merchant, or handler of a commodity in the manner in which such business is customarily and usually conducted by others,

⟦(ii) are active business gains or losses from the sale of commodities, but only if substantially all of the controlled foreign corporation's business is as an active producer, processor, merchant, or handler of commodities, or⟧

(i) arise out of commodity hedging transactions (as defined in paragraph (6)(A)),

(ii) are active business gains or losses from the sale of commodities, but only if substantially all of the controlled foreign corporation's commodities are property described in paragraph (1), (2), or (8) of section 1221(a), or

* * * * * * *

(H) PERSONAL SERVICE CONTRACTS.—

(i) Amounts received under a contract under which the corporation is to furnish personal services if—

(I) some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or

(II) the individual who is to perform the services is designated (by name or by description) in the contract, and

(ii) amounts received from the sale or other disposition of such a contract.

This subparagraph shall apply with respect to amounts received for services under a particular contract only if at some time during the taxable year 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the individual who has performed, is to perform, or may be designated (by name or by description) as the one to perform, such services.

(2) EXCEPTION FOR CERTAIN AMOUNTS.—

(A) RENTS AND ROYALTIES DERIVED IN ACTIVE BUSINESS.—Foreign personal holding company income shall not include rents and royalties which are derived in the active conduct of a trade or business and which are received from a person other than a related person (within the meaning of subsection (d)(3)). *For purposes of the preceding sentence, rents derived from leasing an aircraft or vessel in foreign commerce shall not fail to be treated as derived in the active conduct of a trade or business if, as determined under regulations prescribed by the Secretary, the active leasing expenses are not less than 10 percent of the profit on the lease.*

* * * * * * *

(4) LOOK-THRU IN THE CASE OF RELATED CONTROLLED FOREIGN CORPORATIONS.—For purposes of this subsection, dividends, interest, rents, and royalties received or accrued from a controlled foreign corporation which is a related person (as defined in subsection (d)(3)) shall not be treated as foreign personal holding company income to the extent attributable or properly allocable (determined under rules similar to the rules of subparagraphs (C) and (D) of section 904(d)(3)) to income of the related person which is not subpart F income (as defined in section 952). The Secretary shall prescribe such regulations as may be appropriate to prevent the abuse of the purposes of this paragraph.

(5) LOOK-THRU RULE FOR CERTAIN PARTNERSHIP SALES.—

(A) IN GENERAL.—In the case of any sale by a controlled foreign corporation of an interest in a partnership with respect to which such corporation is a 25-percent owner, such corporation shall be treated for purposes of this subsection as selling the proportionate share of the assets of the partnership attributable to such interest.

(B) 25-PERCENT OWNER.—For purposes of this paragraph, the term "25-percent owner" means a controlled foreign corporation which owns (within the meaning of section 958(a)) 25 percent or more of the capital or profits interest in the partnership.

(6) DEFINITION AND SPECIAL RULES RELATING TO COMMODITY TRANSACTIONS.—

(A) COMMODITY HEDGING TRANSACTIONS.—For purposes of paragraph (1)(C)(i), the term "commodity hedging trans-

action" means any transaction with respect to a commodity if such transaction—

(i) is a hedging transaction as defined in section 1221(b)(2), determined—

(I) without regard to subparagraph (A)(ii) thereof,

(II) by applying subparagraph (A)(i) thereof by substituting "ordinary property or property described in section 1231(b)" for "ordinary property", and

(III) by substituting "controlled foreign corporation" for "taxpayer" each place it appears, and

(ii) is clearly identified as such in accordance with section 1221(a)(7).

(B) REGULATIONS.—The Secretary shall prescribe such regulations as are appropriate to carry out the purposes of paragraph (1)(C) in the case of transactions involving related persons.

(d) FOREIGN BASE COMPANY SALES INCOME.—

(1) * * *

* * * * * * *

(5) TREATMENT OF MEMBER STATES OF THE EUROPEAN UNION.—For purposes of this subsection and subsection (e), in the case of a controlled foreign corporation which is created or organized under the laws of a member state of the European Union, all member states of the European Union shall be treated as 1 country.

* * * * * * *

[(f) FOREIGN BASE COMPANY SHIPPING INCOME.—For purposes of subsection (a)(4), the term "foreign base company shipping income" means income derived from, or in connection with, the use (or hiring or leasing for use) of any aircraft or vessel in foreign commerce, or from, or in connection with the performance of services directly related to the use of any such aircraft, or vessel, or from the sale, exchange, or other disposition of any such aircraft or vessel. Such term includes, but is not limited to—

[(1) dividends and interest received from a foreign corporation in respect of which taxes are deemed paid under section 902, and gain from the sale, exchange, or other disposition of stock or obligations of such a foreign corporation to the extent that such dividends, interest, and gains are attributable to foreign base company shipping income, and

[(2) that portion of the distributive share of the income of a partnership attributable to foreign base company shipping income.

Such term includes any income derived from a space or ocean activity (as defined in section 863(d)(2)). Except as provided in paragraph (1), such term shall not include any dividend or interest income which is foreign personal holding company income (as defined in subsection (c)).]

(g) FOREIGN BASE COMPANY OIL RELATED INCOME.—For purposes of this section—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the term "foreign base company oil related income"

means foreign oil related income (within the meaning of paragraphs (2) and (3) of section 907(c)) other than income derived from a source within a foreign country in connection with—

(A) oil or gas which was extracted from an oil or gas well located in such foreign country, [or]

(B) oil, gas, or a primary product of oil or gas which is sold by the foreign corporation or a related person for use or consumption within such country or is loaded in such country on a vessel or aircraft as fuel for such vessel or aircraft[.]*, or*

(C) the pipeline transportation of oil or gas within such foreign country.

Such term shall not include any foreign personal holding company income (as defined in subsection (c)).

* * * * * * *

(h) SPECIAL RULE FOR INCOME DERIVED IN THE ACTIVE CONDUCT OF BANKING, FINANCING, OR SIMILAR BUSINESSES.—

(1) * * *

* * * * * * *

(3) QUALIFIED BANKING OR FINANCING INCOME.—For purposes of this subsection—

(A) * * *

* * * * * * *

(E) DIRECT CONDUCT OF ACTIVITIES.—For purposes of subparagraph (A)(ii)(II), an activity shall be treated as conducted directly by an eligible controlled foreign corporation or qualified business unit in its home country if the activity is performed by employees of a related person and—

(i) the related person is an eligible controlled foreign corporation the home country of which is the same as the home country of the corporation or unit to which subparagraph (A)(ii)(II) is being applied,

(ii) the activity is performed in the home country of the related person, and

(iii) the related person is compensated on an arm's-length basis for the performance of the activity by its employees and such compensation is treated as earned by such person in its home country for purposes of the home country's tax laws.

* * * * * * *

SEC. 956. INVESTMENT OF EARNINGS IN UNITED STATES PROPERTY.

(a) * * *

* * * * * * *

(c) UNITED STATES PROPERTY DEFINED.—

(1) * * *

(2) EXCEPTIONS.—For purposes of subsection (a), the term "United States property" does not include—

[(A) obligations of the United States, money, or deposits with persons carrying on the banking business;]

(A) obligations of the United States, money, or deposits with any corporation with respect to which a bank holding company (within the meaning of section 2(a) of the Bank

Holding Company Act of 1956 (12 U.S.C. 1841(a))) or financial holding company (within the meaning of section 2(p) of such Act) owns directly or indirectly more than 80 percent by vote or value of the stock of such corporation;

* * * * * * *

(J) deposits of cash or securities made or received on commercial terms in the ordinary course of a United States or foreign person's business as a dealer in securities or in commodities, but only to the extent such deposits are made or received as collateral or margin for (i) a securities loan, notional principal contract, options contract, forward contract, or futures contract, or (ii) any other financial transaction in which the Secretary determines that it is customary to post collateral or margin; **[**and**]**

(K) an obligation of a United States person to the extent the principal amount of the obligation does not exceed the fair market value of readily marketable securities sold or purchased pursuant to a sale and repurchase agreement or otherwise posted or received as collateral for the obligation in the ordinary course of its business by a United States or foreign person which is a dealer in securities or commodities**[**.**]***; and*

(L) securities acquired and held by a controlled foreign corporation in the ordinary course of its business as a dealer in securities if—

(i) the dealer accounts for the securities as securities held primarily for sale to customers in the ordinary course of business, and

(ii) the dealer disposes of the securities (or such securities mature while held by the dealer) within a period consistent with the holding of securities for sale to customers in the ordinary course of business.

For purposes of subparagraphs (J) **[**and (K)**]***, (K), and (L)*, the term "dealer in securities" has the meaning given such term by section 475(c)(1), and the term "dealer in commodities" has the meaning given such term by section 475(e), except that such term shall include a futures commission merchant.

* * * * * * *

Subpart J—Foreign Currency Transactions

* * * * * * *

SEC. 986. DETERMINATION OF FOREIGN TAXES AND FOREIGN CORPORATION'S EARNINGS AND PROFITS.

(a) FOREIGN INCOME TAXES.—

(1) TRANSLATION OF ACCRUED TAXES.—

(A) * * *

* * * * * * *

(D) ELECTIVE EXCEPTION FOR TAXES PAID OTHER THAN IN FUNCTIONAL CURRENCY.—

(i) IN GENERAL.—At the election of the taxpayer, subparagraph (A) shall not apply to any foreign income taxes the liability for which is denominated in any currency other than in the taxpayer's functional currency.

(ii) APPLICATION TO QUALIFIED BUSINESS UNITS.—An election under this subparagraph may apply to foreign income taxes attributable to a qualified business unit in accordance with regulations prescribed by the Secretary.

(iii) ELECTION.—Any such election shall apply to the taxable year for which made and all subsequent taxable years unless revoked with the consent of the Secretary.

[(D)] *(E)* CROSS REFERENCE.—

For adjustments where tax is not paid within 2 years, see section 905(c).

* * * * * * *

SEC. 989. OTHER DEFINITIONS AND SPECIAL RULES.

(a) * * *

(b) APPROPRIATE EXCHANGE RATE.—Except as provided in regulations, for purposes of this subpart, the term "appropriate exchange rate" means—

(1) * * *

* * * * * * *

(3) in the case of any amounts included in income under section 951(a)(1)(A)[, 551(a),] or 1293(a), the average exchange rate for the taxable year of the foreign corporation, or

* * * * * * *

Subchapter O—Gain or Loss on Disposition of Property

* * * * * * *

PART II—BASIS RULES OF GENERAL APPLICATION

* * * * * * *

SEC. 1014. BASIS OF PROPERTY ACQUIRED FROM A DECEDENT.

(a) * * *

(b) PROPERTY ACQUIRED FROM THE DECEDENT.—For purposes of subsection (a), the following property shall be considered to have been acquired from or to have passed from the decedent:

(1) * * *

* * * * * * *

(5) In the case of decedents dying after August 26, 1937, *and before January 1, 2008,* property acquired by bequest, devise, or inheritance or by the decedent's estate from the decedent, if the property consists of stock or securities of a foreign corporation, which with respect to its taxable year next preceding the date of the decedent's death was, under the law applicable to such year, a foreign personal holding company. In such case, the basis shall be the fair market value of such property at the date of the decedent's death or the basis in the hands of the decedent, whichever is lower;

* * * * * * *

SEC. 1016. ADJUSTMENTS TO BASIS.

(a) GENERAL RULE.—Proper adjustment in respect of the property shall in all cases be made—

(1) * * *

* * * * * * *

[(13) to the extent provided in section 551(e) in the case of the stock of United States shareholders in a foreign personal holding company;]

* * * * * * *

PART III—COMMON NONTAXABLE EXCHANGES

* * * * * * *

SEC. 1033. INVOLUNTARY CONVERSIONS.

(a) * * *

* * * * * * *

(e) LIVESTOCK SOLD ON ACCOUNT OF DROUGHT, FLOOD, OR OTHER WEATHER-RELATED [CONDITIONS.—For purposes] *CONDITIONS.—*

(1) IN GENERAL.—For purposes of this subtitle, the sale or exchange of livestock (other than poultry) held by a taxpayer for draft, breeding, or dairy purposes in excess of the number the taxpayer would sell if he followed his usual business practices shall be treated as an involuntary conversion to which this section applies if such livestock are sold or exchanged by the taxpayer solely on account of drought, flood, or other weather-related conditions.

(2) EXTENSION OF REPLACEMENT PERIOD.—

(A) IN GENERAL.—In the case of drought, flood, or other weather-related conditions described in paragraph (1) which result in the area being designated as eligible for assistance by the Federal Government, subsection (a)(2)(B) shall be applied with respect to any converted property by substituting "4 years" for "2 years".

(B) FURTHER EXTENSION BY SECRETARY.—The Secretary may extend on a regional basis the period for replacement under this section (after the application of subparagraph (A)) for such additional time as the Secretary determines appropriate if the weather-related conditions which resulted in such application continue for more than 3 years.

* * * * * * *

Subchapter P—Capital Gains and Losses

* * * * * * *

PART I—TREATMENT OF CAPITAL GAINS

* * * * * * *

SEC. 1201. ALTERNATIVE TAX FOR CORPORATIONS.

(a) GENERAL RULE.—If for any taxable year a corporation has a net capital gain and any rate of tax imposed by section 11, 511, or 831(a) or (b) (whichever is applicable) exceeds 35 percent (determined without regard to [the last 2 sentences of section 11(b)(1)] *section 11(b)(5)*, then, in lieu of any such tax, there is hereby imposed a tax (if such tax is less than the tax imposed by such sections) which shall consist of the sum of—

(1) * * *

* * * * * * *

SEC. 1202. PARTIAL EXCLUSION FOR GAIN FROM CERTAIN SMALL BUSINESS STOCK.

(a) * * *

* * * * * * *

(e) ACTIVE BUSINESS REQUIREMENT.—

(1) * * *

* * * * * * *

(4) ELIGIBLE CORPORATION.—For purposes of this subsection, the term "eligible corporation" means any domestic corporation; except that such term shall not include—

(A) * * *

* * * * * * *

(C) a regulated investment company, real estate investment trust, [REMIC, or FASIT] *or REMIC*, and

* * * * * * *

PART II—TREATMENT OF CAPITAL LOSSES

* * * * * * *

SEC. 1212. CAPITAL LOSS CARRYBACKS AND CARRYOVERS.

(a) CORPORATIONS.—

(1) * * *

* * * * * * *

[(3) SPECIAL RULES ON CARRYBACKS.—A net capital loss of a corporation shall not be carried back under paragraph (1)(A) to a taxable year—

[(A) for which it is a foreign personal holding company (as defined in section 552);

[(B) for which it is a regulated investment company (as defined in section 851);

[(C) for which it is a real estate investment trust (as defined in section 856); or

[(D) for which an election made by it under section 1247 is applicable (relating to election by foreign investment companies to distribute income currently).]

(3) SPECIAL RULES ON CARRYBACKS.—A net capital loss of a corporation shall not be carried back under paragraph (1)(A) to a taxable year—

(A) for which it is a regulated investment company (as defined in section 851), or

(B) for which it is a real estate investment trust (as defined in section 856).

* * * * * * *

PART III—GENERAL RULES FOR DETERMINING CAPITAL GAINS AND LOSSES

* * * * * * *

SEC. 1223. HOLDING PERIOD OF PROPERTY.

For purposes of this subtitle—

(1) * * *

* * * * * * *

[(10) In determining the period for which the taxpayer has held trust certificates of a trust to which subsection (d) of section 1246 applies, or the period for which the taxpayer has held stock in a corporation to which subsection (d) of section 1246 applies, there shall be included the period for which the trust or corporation (as the case may be) held the stock of foreign investment companies.]

[(11)] *(10)* In the case of a person acquiring property from a decedent or to whom property passed from a decedent (within the meaning of section 1014(b)), if—

(A) * * *

* * * * * * *

[(12)] *(11)* If—

(A) * * *

* * * * * * *

[(13)] *(12)* In determining the period for which the taxpayer has held qualified replacement property (within the meaning of section 1042(b)) the acquisition of which resulted under section 1042 in the nonrecognition of any part of the gain realized on the sale of qualified securities (within the meaning of section 1042(b)), there shall be included the period for which such qualified securities had been held by the taxpayer.

[(14)] *(13)* In determining the period for which the taxpayer has held property the acquisition of which resulted under section 1043 in the nonrecognition of any part of the gain realized on the sale of other property, there shall be included the period for which such other property had been held as of the date of such sale.

[(15)] *(14)* Except for purposes of sections 1202(a)(2), 1202(c)(2)(A), 1400B(b), and 1400F(b), in determining the period for which the taxpayer has held property the acquisition of which resulted under section 1045 or 1397B in the nonrecognition of any part of the gain realized on the sale of other property, there shall be included the period for which such other property has been held as of the date of such sale.

[(16)] *(15)* If the security to which a securities futures contract (as defined in section 1234B) relates (other than a contract to which section 1256 applies) is acquired in satisfaction of such contract, in determining the period for which the taxpayer has held such security, there shall be included the period for which the taxpayer held such contract if such contract was a capital asset in the hands of the taxpayer.

⟦(17)⟧ *(16)* CROSS REFERENCE.—

For special holding period provision relating to certain partnership distributions, see section 735(b).

* * * * * * *

PART IV—SPECIAL RULES FOR DETERMINING CAPITALGAINS AND LOSSES

* * * * * * *

⟦SEC. 1246. GAIN ON FOREIGN INVESTMENT COMPANY STOCK.

⟦(a) TREATMENT OF GAIN AS ORDINARY INCOME.—

⟦(1) GENERAL RULE.—In the case of a sale or exchange (or a distribution which, under section 302 or 331, is treated as an exchange of stock) after December 31, 1962, of stock in a foreign corporation which was a foreign investment company (as defined in subsection (b)) at any time during the period during which the taxpayer held such stock, any gain shall be treated as ordinary income, to the extent of the taxpayer's ratable share of the earnings and profits of such corporation accumulated for taxable years beginning after December 31, 1962.

⟦(2) RATABLE SHARE.—For purposes of this section, the taxpayer's ratable share shall be determined under regulations prescribed by the Secretary, but shall include only his ratable share of the accumulated earnings and profits of such corporation—

⟦(A) for the period during which the taxpayer held such stock, but

⟦(B) excluding such earnings and profits attributable to—

⟦(i) any amount previously included in the gross income of such taxpayer under section 951 (but only to the extent the inclusion of such amount did not result in an exclusion of any other amount from gross income under section 959), or

⟦(ii) any taxable year during which such corporation was not a foreign investment company but only if—

⟦(I) such corporation was not a foreign investment company at any time before such taxable year, and

⟦(II) such corporation was treated as a foreign investment company solely by reason of subsection (b)(2).

⟦(3) TAXPAYER TO ESTABLISH EARNINGS AND PROFITS.—Unless the taxpayer establishes the amount of the accumulated earnings and profits of the foreign investment company and the ratable share thereof for the period during which the taxpayer held such stock, all the gain from the sale or exchange of stock in such company shall be considered as ordinary income.

⟦(4) HOLDING PERIOD OF STOCK MUST BE MORE THAN 1 YEAR.—This section shall not apply with respect to the sale or exchange of stock where the holding period of such stock as of the date of such sale or exchange is 1 year or less.

⟦(b) DEFINITION OF FOREIGN INVESTMENT COMPANY.—For purposes of this section, the term "foreign investment company" means any foreign corporation which, for any taxable year beginning after December 31, 1962, is—

⟦(1) registered under the Investment Company Act of 1940, as amended (15 U.S.C. 80a-1 to 80b-2), either as a management company or as a unit investment trust, or

⟦(2) engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in—

⟦(A) securities (as defined in section 2(a)(36) of the Investment Company Act of 1940, as amended),

⟦(B) commodities, or

⟦(C) any interest (including a futures or forward contract or option) in property described in subparagraph (A) or (B),

at a time when 50 percent or more of the total combined voting power of all classes of stock entitled to vote, or the total value of all classes of stock, was held directly (or indirectly through applying paragraphs (2) and (3) of section 958(a) and paragraph (4) of section 318(a)) by United States persons (as defined in section 7701(a)(30)).

⟦(c) STOCK HAVING TRANSFERRED OR SUBSTITUTED BASIS.—To the extent provided in regulations prescribed by the Secretary, stock in a foreign corporation, the basis of which (in the hands of the taxpayer selling or exchanging such stock) is determined by reference to the basis (in the hands of such taxpayer or any other person) of stock in a foreign investment company, shall be treated as stock of a foreign investment company and held by the taxpayer throughout the holding period for such stock (determined under section 1223).

⟦(d) RULES RELATING TO ENTITIES HOLDING FOREIGN INVESTMENT COMPANY STOCK.—To the extent provided in regulations prescribed by the Secretary—

⟦(1) trust certificates of a trust to which section 677 (relating to income for benefit of grantor) applies, and

⟦(2) stock of a domestic corporation,shall be treated as stock of a foreign investment company and held by the taxpayer throughout the holding period for such certificates or stock (determined under section 1223) in the same proportion that the investment in stock in a foreign investment company by the trust or domestic corporation bears to the total assets of such trust or corporation.

⟦(e) RULES RELATING TO STOCK ACQUIRED FROM A DECEDENT.—

⟦(1) BASIS.—In the case of stock of a foreign investment company acquired by bequest, devise, or inheritance (or by the decedent's estate) from a decedent dying after December 31, 1962, the basis determined under section 1014 shall be reduced (but not below the adjusted basis of such stock in the hands of the decedent immediately before his death) by the amount of the decedent's ratable share of the earnings and profits of such company accumulated after December 31, 1962. Any stock so acquired shall be treated as stock described in subsection (c).

⟦(2) DEDUCTION FOR ESTATE TAX.—If stock to which subsection (a) applies is acquired from a decedent, the taxpayer shall, under regulations prescribed by the Secretary, be allowed (for the taxable year of the sale or exchange) a deduction from gross income equal to that portion of the decedent's estate tax deemed paid which is attributable to the excess of (A) the value at which such stock was taken into account for purposes of determining the value of the decedent's gross estate, over (B) the value at which it would have been so taken into account if such value had been reduced by the amount described in paragraph (1).

⟦(f) INFORMATION WITH RESPECT TO CERTAIN FOREIGN INVESTMENT COMPANIES.—Every United States person who, on the last day of the taxable year of a foreign investment company, owns 5 percent or more in value of the stock of such company shall furnish with respect to such company such information as the Secretary shall by regulations prescribe.

⟦(g) COORDINATION WITH SECTION 1248.—This section shall not apply to any gain to the extent such gain is treated as ordinary income under section 1248 (determined without regard to section 1248(g)(2)).

⟦(h) CROSS REFERENCE.—

For special rules relating to the earnings and profits of foreign investment companies, see section 312(j).

⟦SEC. 1247. ELECTION BY FOREIGN INVESTMENT COMPANIES TO DISTRIBUTE INCOME CURRENTLY.

⟦(a) ELECTION BY FOREIGN INVESTMENT COMPANY.—

⟦(1) IN GENERAL.—If a foreign investment company which is described in section 1246(b)(1) elects (in the manner provided in regulations prescribed by the Secretary) on or before December 31, 1962, with respect to each taxable year beginning after December 31, 1962, to—

⟦(A) distribute to its shareholders 90 percent or more of what its taxable income would be if it were a domestic corporation;

⟦(B) designate in a written notice mailed to its shareholders at any time before the expiration of 45 days after the close of its taxable year the pro rata amount of the amount (determined as if such corporation were a domestic corporation) of the net capital gain of the taxable year; and the portion thereof which is being distributed; and

⟦(C) provide such information as the Secretary deems necessary to carry out the purposes of this section,then section 1246 shall not apply with respect to the qualified shareholders of such company during any taxable year to which such election applies.

⟦(2) SPECIAL RULES.—

⟦(A) COMPUTATION OF TAXABLE INCOME.—For purposes of paragraph (1)(A), the taxable income of the company shall be computed without regard to—

⟦(i) the net capital gain referred to in paragraph (1)(B),

⟦(ii) section 172 (relating to net operating losses), and

⟦(iii) any deduction provided by part VIII of subchapter B (other than the deduction provided by section 248, relating to organizational expenditures).

⟦(B) DISTRIBUTIONS AFTER THE CLOSE OF THE TAXABLE YEAR.—For purposes of paragraph (1)(A), a distribution made after the close of the taxable year and on or before the 15th day of the third month of the next taxable year shall be treated as distributed during the taxable year to the extent elected by the company (in accordance with regulations prescribed by the Secretary) on or before the 15th day of such third month.

⟦(C) CARRYOVER OF CAPITAL LOSSES FROM NONELECTION YEARS DENIED.—In computing the net capital gain referred to in paragraph (1)(B), section 1212 shall not apply to losses incurred in or with respect to taxable years before the first taxable year to which the election applies.

⟦(b) YEARS TO WHICH ELECTION APPLIES.—The election of any foreign investment company under this section shall terminate as of the close of the taxable year preceding its first taxable year in which any of the following occurs:

⟦(1) the company fails to comply with the provisions of subparagraph (A), (B), or

⟦(C) of subsection (a)(1), unless it is shown that such failure is due to reasonable cause and not due to willful neglect,

⟦(2) the company is a foreign personal holding company, or

⟦(3) the company is not a foreign investment company which is described in section 1246(b)(1).

⟦(c) QUALIFIED SHAREHOLDERS.—For purposes of this section—

⟦(1) IN GENERAL.—The term "qualified shareholder" means any shareholder who is a United States person (as defined in section 7701(a)(30)), other than a shareholder described in paragraph (2).

⟦(2) CERTAIN UNITED STATES PERSONS EXCLUDED FROM DEFINITION.—A United States person shall not be treated as a qualified shareholder for the taxable year if for such taxable year (or for any prior taxable year) he did not include, in computing his long-term capital gains in his return for such taxable year, the amount designated by such company pursuant to subsection (a)(1)(B) as his share of the undistributed capital gains of such company for its taxable year ending within or with such taxable year of the taxpayer. The preceding sentence shall not apply with respect to any failure by the taxpayer to treat an amount as provided therein if the taxpayer shows that such failure was due to reasonable cause and not due to willful neglect.

⟦(d) TREATMENT OF DISTRIBUTED AND UNDISTRIBUTED CAPITAL GAINS BY A QUALIFIED SHAREHOLDER.—Every qualified shareholder of a foreign investment company for any taxable year of such company with respect to which an election pursuant to subsection (a) is in effect shall include, in computing his long-term capital gains—

⟦(1) for his taxable year in which received, his pro rata share of the distributed portion of the net capital gain for such taxable year of such company, and

⟦(2) for his taxable year in which or with which the taxable year of such company ends, his pro rata share of the undistributed portion of the net capital gain for such taxable year of such company.

⟦(e) ADJUSTMENTS.—Under regulations prescribed by the Secretary, proper adjustment shall be made—

⟦(1) in the earnings and profits of the electing foreign investment company and a qualified shareholder's ratable share thereof, and

⟦(2) in the adjusted basis of stock of such company held by such shareholder,to reflect such shareholder's inclusion in gross income of undistributed capital gains.

⟦(f) ELECTION BY FOREIGN INVESTMENT COMPANY WITH RESPECT TO FOREIGN TAX CREDIT.—A foreign investment company with respect to which an election pursuant to subsection (a) is in effect and more than 50 percent of the value (as defined in section 851(c)(4)) of whose total assets at the close of the taxable year consists of stock or securities in foreign corporations may, for such taxable year, elect the application of this subsection with respect to income, war profits, and excess profits taxes described in section 901(b)(1) which are paid by the foreign investment company during such taxable year to foreign countries and possessions of the United States. If such election is made—

⟦(1) the foreign investment company—

⟦(A) shall compute its taxable income, for purposes of subsection (a)(1)(A), without any deductions for income, war profits, or excess profits taxes paid to foreign countries or possessions of the United States, and

⟦(B) shall treat the amount of such taxes, for purposes of subsection (a)(1)(A), as distributed to its shareholders;

⟦(2) each qualified shareholder of such foreign investment company—

⟦(A) shall include in gross income and treat as paid by him his proportionate share of such taxes, and

⟦(B) shall treat, for purposes of applying subpart A of part III of subchapter N, his proportionate share of such taxes as having been paid to the country in which the foreign investment company is incorporated, and

⟦(C) shall treat as gross income from sources within the country in which the foreign investment company is incorporated, for purposes of applying subpart A of part III of subchapter N, the sum of his proportionate share of such taxes and any dividend paid to him by such foreign investment company.

⟦(g) NOTICE TO SHAREHOLDERS.—The amounts to be treated by qualified shareholders, for purposes of subsection (f)(2), as their proportionate share of the taxes described in subsection (f)(1)(A) paid by a foreign investment company shall not exceed the amounts so designated by the foreign investment company in a written notice mailed to its shareholders not later than 45 days after the close of its taxable year.

❲(h) MANNER OF MAKING ELECTION AND NOTIFYING SHAREHOLDERS.—The election provided in subsection (f) and the notice to shareholders required by subsection (g) shall be made in such manner as the Secretary may prescribe by regulations.

❲(i) LOSS ON SALE OR EXCHANGE OF CERTAIN STOCK HELD LESS THAN 1 YEAR.—If—

❲(1) under this section, any qualified shareholder treats any amount designated under subsection (a)(1)(B) with respect to a share of stock as long-term capital gain, and

❲(2) such share is held by the taxpayer for less than 1 year, then any loss on the sale or exchange of such share shall, to the extent of the amount described in paragraph (1), be treated as loss from the sale or exchange of a capital asset held for more than 1 year.❳

* * * * * * *

SEC. 1248. GAIN FROM CERTAIN SALES OR EXCHANGES OF STOCK IN CERTAIN FOREIGN CORPORATIONS.

(a) * * *

* * * * * * *

(d) EXCLUSIONS FROM EARNINGS AND PROFITS.—For purposes of this section, the following amounts shall be excluded, with respect to any United States person, from the earnings and profits of a foreign corporation:

(1) * * *

* * * * * * *

❲(5) AMOUNTS INCLUDED IN GROSS INCOME UNDER SECTION 1247.—If the United States person whose stock is sold or exchanged was a qualified shareholder (as defined in section 1247(c)) of a foreign corporation which was a foreign investment company (as described in section 1246(b)(1)), the earnings and profits of the foreign corporation for taxable years in which such person was a qualified shareholder.❳

❲(6)❳ *(5)* FOREIGN TRADE INCOME.—Earnings and profits of the foreign corporation attributable to foreign trade income of a FSC other than foreign trade income which—

(A) * * *

* * * * * * *

❲(7)❳ *(6)* AMOUNTS INCLUDED IN GROSS INCOME UNDER SECTION 1293.—Earnings and profits of the foreign corporation attributable to any amount previously included in the gross income of such person under section 1293 with respect to the stock sold or exchanged, but only to the extent the inclusion of such amount did not result in an exclusion of an amount under section 1293(c).

* * * * * * *

SEC. 1260. GAINS FROM CONSTRUCTIVE OWNERSHIP TRANSACTIONS.

(a) * * *

* * * * * * *

(c) FINANCIAL ASSET.—For purposes of this section—

(1) * * *

(2) PASS-THRU ENTITY.—For purposes of paragraph (1), the term "pass-thru entity" means—

(A) * * *

* * * * * * *

【(H) a foreign personal holding company,

【(I) a foreign investment company (as defined in section 1246(b)), and】

【(J)】 *(H)* a REMIC.

* * * * * * *

PART V—SPECIAL RULES FOR BONDS AND OTHER DEBT INSTRUMENTS

* * * * * * *

Subpart A—Original Issue Discount

* * * * * * *

SEC. 1272. CURRENT INCLUSION IN INCOME OF ORIGINAL ISSUE DISCOUNT.

(a) ORIGINAL ISSUE DISCOUNT ON DEBT INSTRUMENTS ISSUED AFTER JULY 1, 1982, INCLUDED IN INCOME ON BASIS OF CONSTANT INTEREST RATE.—

(1) * * *

* * * * * * *

(6) DETERMINATION OF DAILY PORTIONS WHERE PRINCIPAL SUBJECT TO ACCELERATION.—

(A) * * *

(B) DETERMINATION OF PRESENT VALUE.—For purposes of subparagraph (A), the present value shall be determined on the basis of—

(i) * * *

* * * * * * *

For purposes of clause (iii), the Secretary shall prescribe regulations permitting the use of a current prepayment assumption, determined as of the close of the accrual period (or such other time as the Secretary may prescribe during the taxable year in which the accrual period ends).

* * * * * * *

SEC. 1274. DETERMINATION OF ISSUE PRICE IN THE CASE OF CERTAIN DEBT INSTRUMENTS ISSUED FOR PROPERTY.

(a) * * *

(b) IMPUTED PRINCIPAL AMOUNT.—For purposes of this section—

(1) * * *

* * * * * * *

(3) FAIR MARKET VALUE RULE IN POTENTIALLY ABUSIVE SITUATIONS.—

(A) * * *

(B) POTENTIALLY ABUSIVE SITUATION DEFINED.—For purposes of subparagraph (A), the term "potentially abusive situation" means—

(i) a tax shelter (as defined in ⟦section 6662(d)(2)(C)(iii)⟧ *section 6662(d)(2)(C)(ii)*), and

* * * * * * *

Subpart D—Miscellaneous Provisions

* * * * * * *

SEC. 1286. TAX TREATMENT OF STRIPPED BONDS.

(a) * * *

* * * * * * *

(e) DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

(1) * * *

* * * * * * *

(7) CROSS REFERENCE.—

For treatment of stripped interests in certain accounts or entities holding preferred stock, see section 1286(f).

* * * * * * *

(f) TREATMENT OF STRIPPED INTERESTS IN BOND AND PREFERRED STOCK FUNDS, ETC.—In the case of an account or entity substantially all of the assets of which consist of bonds, preferred stock, or a combination thereof, the Secretary may by regulations provide that rules similar to the rules of this section and 305(e), as appropriate, shall apply to interests in such account or entity to which (but for this subsection) this section or section 305(e), as the case may be, would not apply.

⟦(f)⟧ *(g)* REGULATION AUTHORITY.—The Secretary may prescribe regulations providing that where, by reason of varying rates of interest, put or call options, or other circumstances, the tax treatment under this section does not accurately reflect the income of the holder of a stripped coupon or stripped bond, or of the person disposing of such bond or coupon, as the case may be, for any period, such treatment shall be modified to require that the proper amount of income be included for such period.

* * * * * * *

PART VI—TREATMENT OF CERTAIN PASSIVE FOREIGN INVESTMENT COMPANIES

* * * * * * *

Subpart A—Interest on Tax Deferral

* * * * * * *

SEC. 1291. INTEREST ON TAX DEFERRAL.

(a) * * *

* * * * * * *

(b) EXCESS DISTRIBUTION.—

(1) * * *

* * * * * * *

(3) ADJUSTMENTS.—Under regulations prescribed by the Secretary—

(A) * * *

* * * * * * *

(F) proper adjustment shall be made for amounts not includible in gross income by reason of section [551(d), 959(a),] *959(a)* or 1293(c), and

* * * * * * *

(e) Certain basis, etc., rules made applicableExcept to the extent inconsistent with the regulations prescribed under subsection (f), rules similar to the rules of subsections (c), (d), (e), and (f) of section 1246 *(as in effect on the day before the date of the enactment of the American Jobs Creation Act of 2003)* shall apply for purposes of this section; except that—

(1) * * *

* * * * * * *

Subpart B—Treatment of Qualified Electing Funds

* * * * * * *

SEC. 1294. ELECTION TO EXTEND TIME FOR PAYMENT OF TAX ON UNDISTRIBUTED EARNINGS.

(a) EXTENSION ALLOWED BY ELECTION.—

(1) * * *

[(2) ELECTION NOT PERMITTED WHERE AMOUNTS OTHERWISE INCLUDIBLE UNDER SECTION 551 OR 951.—The taxpayer may not make an election under paragraph (1) with respect to the undistributed PFIC earnings tax liability attributable to a qualified electing fund for the taxable year if—

[(A) any amount is includible in the gross income of the taxpayer under section 551 with respect to such fund for such taxable year, or

[(B) any amount is includible in the gross income of the taxpayer under section 951 with respect to such fund for such taxable year.]

(2) ELECTION NOT PERMITTED WHERE AMOUNTS OTHERWISE INCLUDIBLE UNDER SECTION 951.—The taxpayer may not make an election under paragraph (1) with respect to the undistributed PFIC earnings tax liability attributable to a qualified electing fund for the taxable year if any amount is includible in the gross income of the taxpayer under section 951 with respect to such fund for such taxable year.

* * * * * * *

Subchapter S—Tax Treatment of S Corporations and Their Shareholders

* * * * * * *

PART I—IN GENERAL

* * * * * * *

SEC. 1361. S CORPORATION DEFINED

(a) * * *

(b) SMALL BUSINESS CORPORATION.—

(1) IN GENERAL.—For purposes of this subchapter, the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not—

(A) have more than [75] *100* shareholders,

* * * * * * *

(3) TREATMENT OF CERTAIN WHOLLY OWNED SUBSIDIARIES.—

(A) IN GENERAL.—Except as provided in regulations prescribed by the Secretary *and in the case of information returns required under part III of subchapter A of chapter 61*, for purposes of this title—

(i) * * *

* * * * * * *

(c) SPECIAL RULES FOR APPLYING SUBSECTION (B).—

[(1) HUSBAND AND WIFE TREATED AS 1 SHAREHOLDER.—For purposes of subsection (b)(1)(A), a husband and wife (and their estates) shall be treated as 1 shareholder.]

(1) MEMBERS OF FAMILY TREATED AS 1 SHAREHOLDER.—

(A) IN GENERAL.—For purpose of subsection (b)(1)(A)—

i) except as provided in clause (ii), a husband and wife (and their estates) shall be treated as 1 shareholder, and

(ii) in the case of a family with respect to which an election is in effect under subparagraph (D), all members of the family shall be treated as 1 shareholder.

(B) MEMBERS OF THE FAMILY.—For purpose of subparagraph (A)(ii)—

(i) IN GENERAL.—The term "members of the family" means the common ancestor, lineal descendants of the common ancestor, and the spouses (or former spouses) of such lineal descendants or common ancestor.

(ii) COMMON ANCESTOR.—For purposes of this paragraph, an individual shall not be considered a common ancestor if, as of the later of the effective date of this paragraph or the time the election under section 1362(a) is made, the individual is more than 3 generations removed from the youngest generation of shareholders who would (but for this clause) be members of the family. For purposes of the preceding sentence, a spouse (or former spouse) shall be treated as being of the same generation as the individual to which such spouse is (or was) married.

(C) EFFECT OF ADOPTION, ETC.—In determining whether any relationship specified in subparagraph (B) exists, the rules of section 152(b)(2) shall apply.

(D) ELECTION.—An election under subparagraph (A)(ii)—

(i) may, except as otherwise provided in regulations prescribed by the Secretary, be made by any member of the family, and

(ii) shall remain in effect until terminated as provided in regulations prescribed by the Secretary.

(2) CERTAIN TRUSTS PERMITTED AS SHAREHOLDERS.—

(A) IN GENERAL.—For purposes of subsection (b)(1)(B), the following trusts may be shareholders:

(i) * * *

*   *   *   *   *   *   *

(vi) In the case of a corporation which is a bank (as defined in section 581), a trust which constitutes an individual retirement account under section 408(a), including one designated as a Roth IRA under section 408A, but only to the extent of the stock held by such trust in such bank as of the date of the enactment of this clause.

*   *   *   *   *   *   *

(B) TREATMENT AS SHAREHOLDERS.—For purposes of subsection (b)(1)—

(i) * * *

*   *   *   *   *   *   *

(vi) In the case of a trust described in clause (vi) of subparagraph (A), the individual for whose benefit the trust was created shall be treated as a shareholder.

(d) SPECIAL RULE FOR QUALIFIED SUBCHAPTER S TRUST.—

(1) IN GENERAL.—In the case of a qualified subchapter S trust with respect to which a beneficiary makes an election under paragraph (2)—

(A) such trust shall be treated as a trust described in subsection (c)(2)(A)(i), ❲and❳

(B) for purposes of section 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust which consists of stock in an S corporation with respect to which the election under paragraph (2) is made❲.❳*, and*

(C) for purposes of applying sections 465 and 469 to the beneficiary of the trust, the disposition of the S corporation stock by the trust shall be treated as a disposition by such beneficiary.

*   *   *   *   *   *   *

(e) ELECTING SMALL BUSINESS TRUST DEFINED.—

(1) * * *

(2) POTENTIAL CURRENT BENEFICIARY.—For purposes of this section, the term "potential current beneficiary" means, with respect to any period, any person who at any time during such period is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust *(determined without regard to any power of appointment to the extent such power remains unexercised at the end of such period)*. If a trust disposes of all of the stock which it holds in an S corporation, then, with respect to such corporation, the term "potential current beneficiary" does not include any person who first met the requirements of the preceding sentence during the ❲60-day❳ *1-year* period ending on the date of such disposition.

(f) RESTRICTED BANK DIRECTOR STOCK.—

(1) IN GENERAL.—Restricted bank director stock shall not be taken into account as outstanding stock of the S corporation in applying this subchapter (other than section 1368(f)).

(2) RESTRICTED BANK DIRECTOR STOCK.—For purposes of this subsection, the term "restricted bank director stock" means stock in a bank (as defined in section 581), a bank holding company (within the meaning of section 2(a) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(a))), or a financial holding company (within the meaning of section 2(p) of such Act), registered with the Federal Reserve System if such stock—

(A) is required to be held by an individual under applicable Federal or State law in order to permit such individual to serve as a director, and

(B) is subject to an agreement with such bank or company (or a corporation which controls (within the meaning of section 368(c)) such bank or company) pursuant to which the holder is required to sell back such stock (at the same price as the individual acquired such stock) upon ceasing to hold the office of director.

(3) CROSS REFERENCE.—

For treatment of certain distributions with respect to restricted bank director stock, see section 1368(f).

* * * * * * *

SEC. 1362. ELECTION; REVOCATION; TERMINATION.

(a) * * *

* * * * * * *

(d) TERMINATION.—

(1) * * *

* * * * * * *

(3) WHERE PASSIVE INVESTMENT INCOME EXCEEDS 25 PERCENT OF GROSS RECEIPTS FOR 3 CONSECUTIVE TAXABLE YEARS AND CORPORATION HAS ACCUMULATED EARNINGS AND PROFITS.—

(A) * * *

* * * * * * *

(F) EXCEPTION FOR BANKS; ETC.—In the case of a bank (as defined in section 581), a bank holding company (within the meaning of section 2(a) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(a))), or a financial holding company (within the meaning of section 2(p) of such Act), the term "passive investment income" shall not include—

(i) interest income earned by such bank or company, or

(ii) dividends on assets required to be held by such bank or company, including stock in the Federal Reserve Bank, the Federal Home Loan Bank, or the Federal Agricultural Mortgage Bank or participation certificates issued by a Federal Intermediate Credit Bank.

* * * * * * *

(f) INADVERTENT INVALID ELECTIONS OR TERMINATIONS.—If—

(1) an election under subsection (a)*, section 1361(b)(3)(B)(ii), or section 1361(c)(1)(A)(ii)* by any corporation—

(A) was not effective for the taxable year for which made (determined without regard to subsection (b)(2)) by reason of a failure to meet the requirements of section 1361(b) or to obtain shareholder consents, or

(B) was terminated under paragraph (2) or (3) of subsection (d)*, section 1361(b)(3)(C), or section 1361(c)(1)(D)(iii)*,

* * * * * * *

(3) no later than a reasonable period of time after discovery of the circumstances resulting in such ineffectiveness or termination, steps were taken—

【(A) so that the corporation is a small business corporation, or】

(A) so that the corporation for which the election was made is a small business corporation or a qualified subchapter S subsidiary, as the case may be, or

* * * * * * *

【(4) the corporation, and each person who was a shareholder in the corporation at any time during the period specified pursuant to this subsection, agrees to make such adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to such period,】

(4) the corporation for which the election was made, and each person who was a shareholder in such corporation at any time during the period specified pursuant to this subsection, agrees to make such adjustments (consistent with the treatment of such corporation as an S corporation or a qualified subchapter S subsidiary, as the case may be) as may be required by the Secretary with respect to such period,

then, notwithstanding the circumstances resulting in such ineffectiveness or termination, such corporation shall be treated as an S corporation *or a qualified subchapter S subsidiary, as the case may be* during the period specified by the Secretary.

* * * * * * *

PART II—TAX TREATMENT OF SHAREHOLDERS

* * * * * * *

SEC. 1366. PASS-THRU OF ITEMS TO SHAREHOLDERS.

(a) Determination of shareholder's tax liability

(1) * * *

* * * * * * *

(d) Special rules for losses and deductions

(1) * * *

【(2) Indefinite carryover of disallowed losses and deductionsAny loss or deduction which is disallowed for any taxable year by reason of paragraph (1) shall be treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder.】

(2) INDEFINITE CARRYOVER OF DISALLOWED LOSSES AND DEDUCTIONS.—

(A) IN GENERAL.—Except as provided in subparagraph (B), any loss or deduction which is disallowed for any taxable year by reason of paragraph (1) shall be treated as in-

curred by the corporation in the succeeding taxable year with respect to that shareholder.

(B) TRANSFERS OF STOCK BETWEEN SPOUSES OR INCIDENT TO DIVORCE.—In the case of any transfer described in section 1041(a) of stock of an S corporation, any loss or deduction described in subparagraph (A) with respect such stock shall be treated as incurred by the corporation in the succeeding taxable year with respect to the transferee.

SEC. 1368. DISTRIBUTIONS.

(a) * * *

* * * * * * *

(f) RESTRICTED BANK DIRECTOR STOCK.—If a director receives a distribution (not in part or full payment in exchange for stock) from an S corporation with respect to any restricted bank director stock (as defined in section 1361(f)), the amount of such distribution—

(1) shall be includible in gross income of the director, and

(2) shall be deductible by the corporation for the taxable year of such corporation in which or with which ends the taxable year in which such amount in included in the gross income of the director.

* * * * * * *

Subchapter T—Cooperatives and Their Patrons

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PART III—DEFINITIONS; SPECIAL RULES

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SEC. 1388. DEFINITIONS; SPECIAL RULES.

(a) PATRONAGE DIVIDEND.—For purposes of this subchapter, the term “patronage dividend” means an amount paid to a patron by an organization to which part I of this subchapter applies—

(1) * * *

* * * * * * *

Such term does not include any amount paid to a patron to the extent that (A) such amount is out of earnings other than from business done with or for patrons, or (B) such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions. *For purposes of paragraph (3), net earnings shall not be reduced by amounts paid during the year as dividends on capital stock or other proprietary capital interests of the organization to the extent that the articles of incorporation or bylaws of such organization or other contract with patrons provide that such dividends are in addition to amounts otherwise payable to patrons which are derived from business done with or for patrons during the taxable year.*

* * * * * * *

CHAPTER 3—WITHHOLDING OF TAX ON NONRESIDENT ALIENS AND FOREIGN CORPORATIONS

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Subchapter A—Nonresident Aliens and Foreign Corporations

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SEC. 1441. WITHHOLDING OF TAX ON NONRESIDENT ALIENS.

(a) * * *

* * * * * * *

(c) EXCEPTIONS.—

(1) * * *

* * * * * * *

(12) CERTAIN DIVIDENDS RECEIVED FROM REGULATED INVESTMENT COMPANIES.—

(A) IN GENERAL.—No tax shall be required to be deducted and withheld under subsection (a) from any amount exempt from the tax imposed by section 871(a)(1)(A) by reason of section 871(k).

(B) SPECIAL RULE.—For purposes of subparagraph (A), clause (i) of section 871(k)(1)(B) shall not apply to any dividend unless the regulated investment company knows that such dividend is a dividend referred to in such clause. A similar rule shall apply with respect to the exception contained in section 871(k)(2)(B).

* * * * * * *

SEC. 1442. WITHHOLDING OF TAX ON FOREIGN CORPORATIONS.

(a) GENERAL RULE.—In the case of foreign corporations subject to taxation under this subtitle, there shall be deducted and withheld at the source in the same manner and on the same items of income as is provided in section 1441 a tax equal to 30 percent thereof. For purposes of the preceding sentence, the references in section 1441(b) to sections 871(a)(1)(C) and (D) shall be treated as referring to sections 881(a)(3) and (4), the reference in section 1441(c)(1) to section 871(b)(2) shall be treated as referring to section 842 or section 882(a)(2), as the case may be, the reference in section 1441(c)(5) to section 871(a)(1)(D) shall be treated as referring to section 881(a)(4), the reference in section 1441(c)(8) to section 871(a)(1)(C) shall be treated as referring to section 881(a)(3), the references in section 1441(c)(9) to sections 871(h) and 871(h)(3) or (4) shall be treated as referring to sections 881(c) and 881(c)(3) or (4), [and the reference in section 1441(c)(10)] *the reference in section 1441(c)(10)* to section 871(i)(2) shall be treated as referring to section 881(d)*, and the references in section 1441(c)(12) to sections 871(a) and 871(k) shall be treated as referring to sections 881(a) and 881(e) (except that for purposes of applying subparagraph (A) of section 1441(c)(12), as so modified, clause (ii) of section 881(e)(1)(B) shall not apply to any dividend unless the regulated in-*

vestment company knows that such dividend is a dividend referred to in such clause).

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CHAPTER 6—CONSOLIDATED RETURNS

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Subchapter B—Related Rules

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PART II—CERTAIN CONTROLLED CORPORATIONS

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SEC. 1561. LIMITATIONS ON CERTAIN MULTIPLE TAX BENEFITS IN THE CASE OF CERTAIN CONTROLLED CORPORATIONS.

(a) GENERAL RULE.—The component members of a controlled group of corporations on a December 31 shall, for their taxable years which include such December 31, be limited for purposes of this subtitle to—

(1) * * *

* * * * * * *

The amounts specified in paragraph (1), the amount specified in paragraph (3), and the amount specified in paragraph (4) shall be divided equally among the component members of such group on such December 31 unless all of such component members consent (at such time and in such manner as the Secretary shall by regulations prescribe) to an apportionment plan providing for an unequal allocation of such amounts. The amounts specified in paragraph (2) shall be divided equally among the component members of such group on such December 31 unless the Secretary prescribes regulations permitting an unequal allocation of such amounts. Notwithstanding paragraph (1), in applying ⟦the last 2 sentences of section 11(b)(1)⟧ *section 11(b)(5)* to such component members, the taxable income of all such component members shall be taken into account and any increase in tax under ⟦such last 2 sentences⟧ *section 11(b)(5)* shall be divided among such component members in the same manner as amounts under paragraph (1). In applying section 55(d)(3), the alternative minimum taxable income of all component members shall be taken into account and any decrease in the exemption amount shall be allocated to the component members in the same manner as under paragraph (3).

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Subtitle B—Estate and Gift Taxes

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CHAPTER 11—ESTATE TAX

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Subchapter B—Estates of Nonresidents Not Citizens

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SEC. 2105. PROPERTY WITHOUT THE UNITED STATES.

(a) * * *

* * * * * * *

(d) STOCK IN A RIC.—

(1) IN GENERAL.—For purposes of this subchapter, stock in a regulated investment company (as defined in section 851) owned by a nonresident not a citizen of the United States shall not be deemed property within the United States in the proportion that, at the end of the quarter of such investment company's taxable year immediately preceding a decedent's date of death (or at such other time as the Secretary may designate in regulations), the assets of the investment company that were qualifying assets with respect to the decedent bore to the total assets of the investment company.

(2) QUALIFYING ASSETS.—For purposes of this subsection, qualifying assets with respect to a decedent are assets that, if owned directly by the decedent, would have been—

(A) amounts, deposits, or debt obligations described in subsection (b) of this section,

(B) debt obligations described in the last sentence of section 2104(c), or

(C) other property not within the United States.

* * * * * * *

SEC. 2107. EXPATRIATION TO AVOID TAX

⟦(a) TREATMENT OF EXPATRIATES.—

⟦(1) RATE OF TAX.—A tax computed in accordance with the table contained in section 2001 is hereby imposed on the transfer of the taxable estate, determined as provided in section 2106, of every decedent nonresident not a citizen of the United States if, within the 10-year period ending with the date of death, such decedent lost United States citizenship, unless such loss did not have for one of its principal purposes the avoidance of taxes under this subtitle or subtitle A—

⟦(2) CERTAIN INDIVIDUALS TREATED AS HAVING TAX AVOIDANCE PURPOSE.—

⟦(A) IN GENERAL.—For purposes of paragraph (1), an individual shall be treated as having a principal purpose to avoid such taxes if such individual is so treated under section 877(a)(2).

⟦(B) EXCEPTION.—Subparagraph (A) shall not apply to a decedent meeting the requirements of section 877(c)(1).⟧

(a) TREATMENT OF EXPATRIATES.—A tax computed in accordance with the table contained in section 2001 is hereby imposed on the transfer of the taxable estate, determined as provided in section 2106, of every decedent nonresident not a citizen of the United States if the date of death occurs during a taxable year with respect to which the decedent is subject to tax under section 877(b).

* * * * * * *

CHAPTER 12—GIFT TAX

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Subchapter A—Determination of Tax Liability

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SEC. 2501. IMPOSITION OF TAX.

(a) TAXABLE TRANSFERS.—

(1) * * *

* * * * * * *

[(3) EXCEPTION.—

[(A) CERTAIN INDIVIDUALS.—Paragraph (2) shall not apply in the case of a donor who, within the 10-year period ending with the date of transfer, lost United States citizenship, unless such loss did not have for one of its principal purposes the avoidance of taxes under this subtitle or subtitle A.

[(B) CERTAIN INDIVIDUALS TREATED AS HAVING TAX AVOIDANCE PURPOSE.—For purposes of subparagraph (A), an individual shall be treated as having a principal purpose to avoid such taxes if such individual is so treated under section 877(a)(2).

[(C) EXCEPTION FOR CERTAIN INDIVIDUALS.—Subparagraph (B) shall not apply to a donor meeting the requirements of section 877(c)(1).

[(D) CREDIT FOR FOREIGN GIFT TAXES.—The tax imposed by this section solely by reason of this paragraph shall be credited with the amount of any gift tax actually paid to any foreign country in respect of any gift which is taxable under this section solely by reason of this paragraph.

[(E) CROSS REFERENCE.—

[For comparable treatment of long-term lawful permanent residents who ceased to be taxed as residents, see section 877(e).

[(4) BURDEN OF PROOF.—If the Secretary establishes that it is reasonable to believe that an individual's loss of United States citizenship would, but for paragraph (3), result in a substantial reduction for the calendar year in the taxes on the transfer of property by gift, the burden of proving that such loss of citizenship did not have for one of its principal purposes the avoidance of taxes under this subtitle or subtitle A shall be on such individual.]

(3) EXCEPTION.—

(A) CERTAIN INDIVIDUALS.—Paragraph (2) shall not apply in the case of a donor to whom section 877(b) applies for the taxable year which includes the date of the transfer.

(B) CREDIT FOR FOREIGN GIFT TAXES.—The tax imposed by this section solely by reason of this paragraph shall be credited with the amount of any gift tax actually paid to any foreign country in respect of any gift which is taxable under this section solely by reason of this paragraph.

[(5)] *(4)* TRANSFERS TO POLITICAL ORGANIZATIONS.—Paragraph (1) shall not apply to the transfer of money or other property to a political organization (within the meaning of section 527(e)(1)) for the use of such organization.

(5) TRANSFERS OF CERTAIN STOCK.—

(A) IN GENERAL.—In the case of a transfer of stock in a foreign corporation described in subparagraph (B) by a donor to whom section 877(b) applies for the taxable year which includes the date of the transfer—

(i) section 2511(a) shall be applied without regard to whether such stock is situated within the United States, and

(ii) the value of such stock for purposes of this chapter shall be its U.S.-asset value determined under subparagraph (C).

(B) FOREIGN CORPORATION DESCRIBED.—A foreign corporation is described in this subparagraph with respect to a donor if—

(i) the donor owned (within the meaning of section 958(a)) at the time of such transfer 10 percent or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation, and

(ii) such donor owned (within the meaning of section 958(a)), or is considered to have owned (by applying the ownership rules of section 958(b)), at the time of such transfer, more than 50 percent of—

(I) the total combined voting power of all classes of stock entitled to vote of such corporation, or

(II) the total value of the stock of such corporation.

(C) U.S.-ASSET VALUE.—For purposes of subparagraph (A), the U.S.-asset value of stock shall be the amount which bears the same ratio to the fair market value of such stock at the time of transfer as—

(i) the fair market value (at such time) of the assets owned by such foreign corporation and situated in the United States, bears to

(ii) the total fair market value (at such time) of all assets owned by such foreign corporation.

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Subtitle C—Employment Taxes

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CHAPTER 21—FEDERAL INSURANCE CONTRIBUTIONS ACT

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Subchapter C—General Provisions

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SEC. 3121. DEFINITIONS.

(a) WAGES.—For purposes of this chapter, the term "wages" means all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash; except that such term shall not include—

(1) * * *

* * * * * * *

(20) any benefit provided to or on behalf of an employee if at the time such benefit is provided it is reasonable to believe that the employee will be able to exclude such benefit from income under section 74(c), 117, or 132; ⟦or⟧

(21) in the case of a member of an Indian tribe, any remuneration on which no tax is imposed by this chapter by reason of section 7873 (relating to income derived by Indians from exercise of fishing rights)⟦.⟧*; or*

(22) remuneration on account of—

(A) a transfer of a share of stock to any individual pursuant to an exercise of an incentive stock option (as defined in section 422(b)) or under an employee stock purchase plan (as defined in section 423(b)), or

(B) any disposition by the individual of such stock.

* * * * * * *

(v) TREATMENT OF CERTAIN DEFERRED COMPENSATION AND SALARY REDUCTION ARRANGEMENTS.—

(1) * * *

(2) TREATMENT OF CERTAIN NONQUALIFIED DEFERRED COMPENSATION PLANS.—

(A) IN GENERAL.—Any amount deferred under a nonqualified deferred compensation plan shall be taken into account for purposes of this chapter as of the later of—

(i) when the services are performed, or

(ii) when there is no substantial risk of forfeiture of the rights to such amount.

The preceding sentence shall not apply to any excess parachute payment (as defined in section 280G(b)) *or to any specified stock compensation (as defined in section 4985) on which tax is imposed by section 4985*.

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CHAPTER 22—RAILROAD RETIREMENT TAX ACT

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Subchapter D—General Provisions

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SEC. 3231. DEFINITIONS.

(a) * * *

* * * * * * *

(e) COMPENSATION.—For purposes of this chapter—

(1) * * *

* * * * * * *

(11) QUALIFIED STOCK OPTIONS.—The term "compensation" shall not include any remuneration on account of—

(A) a transfer of a share of stock to any individual pursuant to an exercise of an incentive stock option (as defined in section 422(b)) or under an employee stock purchase plan (as defined in section 423(b)), or

(B) any disposition by the individual of such stock.

* * * * * * *

CHAPTER 23—FEDERAL UNEMPLOYMENT TAX ACT

* * * * * * *

SEC. 3306. DEFINITIONS.

(a) * * *

(b) WAGES.—For purposes of this chapter, the term "wages" means all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash; except that such term shall not include—

(1) * * *

* * * * * * *

(16) any benefit provided to or on behalf of an employee if at the time such benefit is provided it is reasonable to believe that the employee will be able to exclude such benefit from income under section 74(c), 117, or 132; **[**or**]**

(17) any payment made to or for the benefit of an employee if at the time of such payment it is reasonable to believe that the employee will be able to exclude such payment from income under section 106(b)**[**.**]***; or*

(18) remuneration on account of—

(A) a transfer of a share of stock to any individual pursuant to an exercise of an incentive stock option (as defined in section 422(b)) or under an employee stock purchase plan (as defined in section 423(b)), or

(B) any disposition by the individual of such stock.

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Subtitle D—Miscellaneous Excise Taxes

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CHAPTER 32—MANUFACTURERS EXCISE TAXES

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Subchapter C—Certain Vaccines

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SEC. 4132. DEFINITIONS AND SPECIAL RULES.

(a) DEFINITIONS RELATING TO TAXABLE VACCINES.—For purposes of this subchapter—

(1) TAXABLE VACCINE.—The term "taxable vaccine" means any of the following vaccines which are manufactured or produced in the United States or entered into the United States for consumption, use, or warehousing:

(A) * * *

* * * * * * *

(I) Any vaccine against hepatitis A.

【(I)】 *(J)* ANY VACCINE AGAINST HEPATITIS B.

【(J)】 *(K)* ANY VACCINE AGAINST CHICKEN POX.

【(K)】 *(L)* ANY VACCINE AGAINST ROTAVIRUS GASTROENTERITIS.

【(L)】 *(M)* ANY CONJUGATE VACCINE AGAINST STREPTOCOCCUS PNEUMONIAE.

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Subchapter D—Recreational Equipment

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PART I—SPORTING GOODS

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SEC. 4161. IMPOSITION OF TAX.

(a) * * *

(b) BOWS AND ARROWS, ETC.—

【(1) BOWS.—

【(A) IN GENERAL.—There is hereby imposed on the sale by the manufacturer, producer, or importer of any bow which has a draw weight of 10 pounds or more, a tax equal to 11 percent of the price for which so sold.

【(B) PARTS AND ACCESSORIES.—There is hereby imposed upon the sale by the manufacturer, producer, or importer—

【(i) of any part of accessory suitable for inclusion in or attachment to a bow described in subparagraph (A), and

【(ii) of any quiver suitable for use with arrows described in paragraph (2), a tax equivalent to 11 percent of the price for which so sold.】

(1) BOWS.—

(A) IN GENERAL.—There is hereby imposed on the sale by the manufacturer, producer, or importer of any bow which has a peak draw weight of 30 pounds or more, a tax equal to 11 percent of the price for which so sold.

(B) ARCHERY EQUIPMENT.—There is hereby imposed on the sale by the manufacturer, producer, or importer—

(i) of any part or accessory suitable for inclusion in or attachment to a bow described in subparagraph (A), and

(ii) of any quiver or broadhead suitable for use with an arrow described in paragraph (3),

a tax equal to 11 percent of the price for which so sold.

(2) [ARROWS.—] *ARROW COMPONENTS.*—There is hereby imposed on the sale by the manufacturer, producer, or importer of any shaft, point *(other than a broadhead)*, nock, or vane of a type used in the manufacture of any arrow which after its assembly—

(A) * * *

* * * * * * *

(3) ARROWS.—

(A) IN GENERAL.—There is hereby imposed on the sale by the manufacturer, producer, or importer of any arrow, a tax equal to 12 percent of the price for which so sold.

(B) EXCEPTION.—The tax imposed by subparagraph (A) on an arrow shall not apply if the arrow contains an arrow shaft with respect to which tax was paid under paragraph (2).

(C) ARROW.—For purposes of this paragraph, the term "arrow" means any shaft described in paragraph (2) to which additional components are attached.

[(3)] *(4)* COORDINATION WITH SUBSECTION (A).—No tax shall be imposed under this subsection with respect to any article taxable under subsection (a).

* * * * * * *

SEC. 4162. DEFINITIONS; TREATMENT OF CERTAIN RESALES.

(a) SPORT FISHING EQUIPMENT DEFINED.—For purposes of this part, the term "sport fishing equipment" means—

(1) * * *

* * * * * * *

(6) the following items of fishing supplies and accessories—

(A) * * *

* * * * * * *

[(C) tackle boxes,]

[(D)] *(C)* bags, baskets, and other containers designed to hold fish,

[(E)] *(D)* portable bait containers,

[(F)] *(E)* fishing vests,

[(G)] *(F)* landing nets,

[(H)] *(G)* gaff hooks,

[(I)] *(H)* fishing hook disgorgers, and

[(J)] *(I)* dressing for fishing lines and artificial flies,

* * * * * * *

(8) fishing rod belts, fishing rodholders, fishing harnesses, fish fighting chairs, fishing outriggers, and fishing downriggers, *and*

(9) electric outboard boat motors[, and].

[(10) sonar devices suitable for finding fish.]

⟦(b) SONAR DEVICE SUITABLE FOR FINDING FISH.—For purposes of this part, the term "sonar device suitable for finding fish" shall not include any sonar device which is—

⟦(1) a graph recorder,

⟦(2) a digital type,

⟦(3) a meter readout, or

⟦(4) a combination graph recorder or combination meter readout.⟧

⟦(c)⟧ *(b)* TREATMENT OF CERTAIN RESALES.—

(1) * * *

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CHAPTER 42—PRIVATE FOUNDATIONS AND CERTAIN OTHER TAX-EXEMPT ORGANIZATIONS

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Subchapter A—Private Foundations

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SEC. 4947. APPLICATION OF TAXES TO CERTAIN NONEXEMPT TRUSTS.

(a) APPLICATION OF TAX.—

(1) CHARITABLE TRUSTS.—For purposes of part II of subchapter F of chapter 1 (other than section 508(a), (b), and (c)) and for purposes of this chapter, a trust which is not exempt from taxation under section 501(a), all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B), and for which a deduction was allowed under section 170, 545(b)(2), ⟦556(b)(2),⟧ 642(c), 2055, 2106(a)(2), or 2522 (or the corresponding provisions of prior law), shall be treated as an organization described in section 501(c)(3). For purposes of section 509(a)(3)(A), such a trust shall be treated as if organized on the day on which it first becomes subject to this paragraph.

(2) SPLIT-INTEREST TRUSTS.—In the case of a trust which is not exempt from tax under section 501(a), not all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B), and which has amounts in trust for which a deduction was allowed under section 170, 545(b)(2), ⟦556(b)(2), 642(c),⟧ 2055, 2106(a)(2), or 2522, section 507 (relating to termination of private foundation status), section 508(e) (relating to governing instruments) to the extent applicable to a trust described in this paragraph, section 4941 (relating to taxes on self-dealing), section 4943 (relating to taxes on excess business holdings) except as provided in subsection (b)(3), section 4944 (relating to investments which jeopardize charitable purpose) except as provided in subsection (b)(3), and section 4945 (relating to taxes on taxable expenditures) shall apply as if such trust were a private foundation. This paragraph shall not apply with respect to—

(A) * * *

(B) any amounts in trust other than amounts for which a deduction was allowed under section 170, 545(b)(2), [556(b)(2),] 642(c), 2055, 2106(a)(2), or 2522, if such other amounts are segregated from amounts for which no deduction was allowable, or

* * * * * * *

(b) SPECIAL RULES.—

(1) * * *

* * * * * * *

(3) SECTIONS 4943 AND 4944.—Sections 4943 and 4944 shall not apply to a trust which is described in subsection (a)(2) if—

(A) all the income interest (and none of the remainder interest) of such trust is devoted solely to one or more of the purposes described in section 170(c)(2)(B), and all amounts in such trust for which a deduction was allowed under section 170, 545(b)(2), [556(b)(2),] 642(c), 2055, 2106(a)(2), or 2522 have an aggregate value not more than 60 percent of the aggregate fair market value of all amounts in such trusts, or

(B) a deduction was allowed under section 170, 545(b)(2), [556(b)(2),] 642(c), 2055, 2106(a)(2), or 2522 for amounts payable under the terms of such trust to every remainder beneficiary but not to any income beneficiary.

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SEC. 4948. APPLICATION OF TAXES AND DENIAL OF EXEMPTION WITH RESPECT TO CERTAIN FOREIGN ORGANIZATIONS.

(a) * * *

* * * * * * *

(c) DENIAL OF EXEMPTION TO FOREIGN ORGANIZATIONS ENGAGED IN PROHIBITED TRANSACTIONS.—

(1) * * *

* * * * * * *

(4) DISALLOWANCE OF CERTAIN CHARITABLE DEDUCTIONS.—No gift or bequest shall be allowed as a deduction under section 170, 545(b)(2), [556(b)(2),] 642(c), 2055, 2106(a)(2), or 2522, if made—

(A) * * *

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CHAPTER 43—QUALIFIED PENSION, ETC., PLANS

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SEC. 4975. TAX ON PROHIBITED TRANSACTIONS.

(a) * * *

* * * * * * *

(d) EXEMPTIONS.—Except as provided in subsection (f)(6), the prohibitions provided in subsection (c) shall not apply to—

(1) * * *

* * * * * * *

(14) any transaction required or permitted under part 1 of subtitle E of title IV or section 4223 of the Employee Retirement Income Security Act of 1974, but this paragraph shall not apply with respect to the application of subsection (c)(1) (E) or (F); **[**or**]**

(15) a merger of multiemployer plans, or the transfer of assets or liabilities between multiemployer plans, determined by the Pension Benefit Guaranty Corporation to meet the requirements of section 4231 of such Act, but this paragraph shall not apply with respect to the application of subsection (c)(1) (E) or (F)**[**.**]***; or*

(16) a sale of stock held by a trust which constitutes an individual retirement account under section 408(a) to the individual for whose benefit such account is established if—

(A) such stock is in a bank (as defined in section 581),

(B) such stock is held by such trust as of the date of the enactment of this paragraph,

(C) such sale is pursuant to an election under section 1362(a) by such bank,

(D) such sale is for fair market value at the time of sale (as established by an independent appraiser) and the terms of the sale are otherwise at least as favorable to such trust as the terms that would apply on a sale to an unrelated party,

(E) such trust does not pay any commissions, costs, or other expenses in connection with the sale, and

(F) the stock is sold in a single transaction for cash not later than 120 days after the S corporation election is made.

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(f) OTHER DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

(1) * * *

* * * * * * *

(7) S CORPORATION REPAYMENT OF LOANS FOR QUALIFYING EMPLOYER SECURITIES.—A plan shall not be treated as violating the requirements of section 401 or 409 or subsection (e)(7), or as engaging in a prohibited transaction for purposes of subsection (d)(3), merely by reason of any distribution (as described in section 1368(a)) with respect to S corporation stock that constitutes qualifying employer securities, which in accordance with the plan provisions is used to make payments on a loan described in subsection (d)(3) the proceeds of which were used to acquire such qualifying employer securities (whether or not allocated to participants). The preceding sentence shall not apply in the case of a distribution which is paid with respect to any employer security which is allocated to a participant unless the plan provides that employer securities with a fair market value of not less than the amount of such distribution are allocated to such participant for the year which (but for the preceding sentence) such distribution would have been allocated to such participant.

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CHAPTER 45—PROVISIONS RELATING TO EXPATRIATED ENTITIES

SEC. 4985. STOCK COMPENSATION OF INSIDERS IN EXPATRIATED CORPORATIONS.

(a) IMPOSITION OF TAX.—In the case of an individual who is a disqualified individual with respect to any expatriated corporation, there is hereby imposed on such person a tax equal to 15 percent of the value (determined under subsection (b)) of the specified stock compensation held (directly or indirectly) by or for the benefit of such individual or a member of such individual's family (as defined in section 267) at any time during the 12-month period beginning on the date which is 6 months before the expatriation date.

(b) VALUE.—For purposes of subsection (a)—

(1) IN GENERAL.—The value of specified stock compensation shall be—

(A) in the case of a stock option (or other similar right) or a stock appreciation right, the fair value of such option or right, and

(B) in any other case, the fair market value of such compensation.

(2) DATE FOR DETERMINING VALUE.—The determination of value shall be made—

(A) in the case of specified stock compensation held on the expatriation date, on such date,

(B) in the case of such compensation which is canceled during the 6 months before the expatriation date, on the day before such cancellation, and

(C) in the case of such compensation which is granted after the expatriation date, on the date such compensation is granted.

(c) TAX TO APPLY ONLY IF SHAREHOLDER GAIN RECOGNIZED.—Subsection (a) shall apply to any disqualified individual with respect to an expatriated corporation only if gain (if any) on any stock in such corporation is recognized in whole or part by any shareholder by reason of the acquisition referred to in section 7874(a)(2)(B)(i) with respect to such corporation.

(d) EXCEPTION WHERE GAIN RECOGNIZED ON COMPENSATION.—Subsection (a) shall not apply to—

(1) any stock option which is exercised on the expatriation date or during the 6-month period before such date and to the stock acquired in such exercise, if income is recognized under section 83 on or before the expatriation date with respect to the stock acquired pursuant to such exercise, and

(2) any other specified stock compensation which is exercised, sold, exchanged, distributed, cashed-out, or otherwise paid during such period in a transaction in which income, gain, or loss is recognized in full.

(e) DEFINITIONS.—For purposes of this section—

(1) DISQUALIFIED INDIVIDUAL.—The term "disqualified individual" means, with respect to a corporation, any individual who, at any time during the 12-month period beginning on the date which is 6 months before the expatriation date—

(A) is subject to the requirements of section 16(a) of the Securities Exchange Act of 1934 with respect to such corporation or any member of the expanded affiliated group which includes such corporation, or

(B) would be subject to such requirements if such corporation or member were an issuer of equity securities referred to in such section.

(2) EXPATRIATED CORPORATION; EXPATRIATION DATE.—

(A) EXPATRIATED CORPORATION.—The term "expatriated corporation" means any corporation which is an expatriated entity (as defined in section 7874(a)(2)). Such term includes any predecessor or successor of such a corporation.

(B) EXPATRIATION DATE.—The term "expatriation date" means, with respect to a corporation, the date on which the corporation first becomes an expatriated corporation.

(3) SPECIFIED STOCK COMPENSATION.—

(A) IN GENERAL.—The term "specified stock compensation" means payment (or right to payment) granted by the expatriated corporation (or by any member of the expanded affiliated group which includes such corporation) to any person in connection with the performance of services by a disqualified individual for such corporation or member if the value of such payment or right is based on (or determined by reference to) the value (or change in value) of stock in such corporation (or any such member).

(B) EXCEPTIONS.—Such term shall not include—

(i) any option to which part II of subchapter D of chapter 1 applies, or

(ii) any payment or right to payment from a plan referred to in section 280G(b)(6).

(4) EXPANDED AFFILIATED GROUP.—The term "expanded affiliated group" means an affiliated group (as defined in section 1504(a) without regard to section 1504(b)(3)); except that section 1504(a) shall be applied by substituting "more than 50 percent" for "at least 80 percent" each place it appears.

(f) SPECIAL RULES.—For purposes of this section—

(1) CANCELLATION OF RESTRICTION.—The cancellation of a restriction which by its terms will never lapse shall be treated as a grant.

(2) PAYMENT OR REIMBURSEMENT OF TAX BY CORPORATION TREATED AS SPECIFIED STOCK COMPENSATION.—Any payment of the tax imposed by this section directly or indirectly by the expatriated corporation or by any member of the expanded affiliated group which includes such corporation—

(A) shall be treated as specified stock compensation, and

(B) shall not be allowed as a deduction under any provision of chapter 1.

(3) CERTAIN RESTRICTIONS IGNORED.—Whether there is specified stock compensation, and the value thereof, shall be determined without regard to any restriction other than a restriction which by its terms will never lapse.

(4) PROPERTY TRANSFERS.—Any transfer of property shall be treated as a payment and any right to a transfer of property shall be treated as a right to a payment.

(5) OTHER ADMINISTRATIVE PROVISIONS.—For purposes of subtitle F, any tax imposed by this section shall be treated as a tax imposed by subtitle A.

(g) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section.

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Subtitle E—Alcohol, Tobacco, and Certain Other Excise Taxes

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CHAPTER 51—DISTILLED SPIRITS, WINES, AND BEER

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Subchapter A—Gallonage and Occupational Taxes

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PART I—GALLONAGE TAXES

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Subpart A—Distilled Spirits

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SEC. 5011. INCOME TAX CREDIT FOR WHOLESALER'S AVERAGE COST OF CARRYING EXCISE TAX.

(a) IN GENERAL.—For purposes of section 38, in the case of an eligible wholesaler, the amount of the distilled spirits wholesalers credit for any taxable year is the amount equal to the product of—

(1) the number of cases of bottled distilled spirits—

(A) which were bottled in the United States, and

(B) which are purchased by such wholesaler during the taxable year directly from the bottler of such spirits, and

(2) the average tax-financing cost per case for the most recent calendar year ending before the beginning of such taxable year.

(b) ELIGIBLE WHOLESALER.—For purposes of this section, the term "eligible wholesaler" means any person who holds a permit under the Federal Alcohol Administration Act as a wholesaler of distilled spirits.

(c) AVERAGE TAX-FINANCING COST.—

(1) IN GENERAL.—For purposes of this section, the average tax-financing cost per case for any calendar year is the amount of interest which would accrue at the deemed financing rate during a 60-day period on an amount equal to the deemed Federal excise per case.

(2) DEEMED FINANCING RATE.—For purposes of paragraph (1), the deemed financing rate for any calendar year is the average of the corporate overpayment rates under paragraph (1) of section 6621(a) (determined without regard to the last sentence of such paragraph) for calendar quarters of such year.

(3) DEEMED FEDERAL EXCISE TAX BASED ON CASE OF 12 80-PROOF 750ML BOTTLES.—For purposes of paragraph (1), the deemed Federal excise tax per case is $22.83.

(4) NUMBER OF CASES IN LOT.—For purposes of this section, the number of cases in any lot of distilled spirits shall be determined by dividing the number of liters in such lot by 9.

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PART II—OCCUPATIONAL TAX

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Subpart D—Wholesale Dealers

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SEC. 5117. PROHIBITED PURCHASES BY DEALERS.

(a) * * *

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(d) SPECIAL RULE DURING SUSPENSION PERIOD.—Except as provided by the Secretary, during the suspension period (as defined in section 5148) it shall be unlawful for any dealer to purchase distilled spirits for resale from any person other than a wholesale dealer in liquors who is required to keep records under section 5114.

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Subpart G—General Provisions

Sec. 5141. Registration.

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[Sec. 5148. Cross references.]
Sec. 5148. Suspension of occupational tax.
Sec. 5149. Cross references.

* * * * * * *

SEC. 5148. SUSPENSION OF OCCUPATIONAL TAX.

(a) IN GENERAL.—Notwithstanding sections 5081, 5091, 5111, 5121, and 5131, the rate of tax imposed under such sections for the suspension period shall be zero. During such period, persons engaged in or carrying on a trade or business covered by such sections shall register under section 5141 and shall comply with the recordkeeping requirements under this part.

(b) SUSPENSION PERIOD.—For purposes of subsection (a), the suspension period is the period beginning on July 1, 2004, and ending on June 30, 2007.

SEC. [5148.] *5149.* CROSS REFERENCES.

(1) For penalties for willful nonpayment of special taxes, see section 5691.

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Subtitle F—Procedure and Administration

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CHAPTER 61—INFORMATION AND RETURNS

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Subchapter A—Returns and Records

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PART III—INFORMATION RETURNS

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Subpart A—Information Concerning Persons Subject to Special Provisions

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[SEC. 6035. RETURNS OF OFFICERS, DIRECTORS, AND SHAREHOLDERS OF FOREIGN PERSONAL HOLDING COMPANIES.

[(a) GENERAL RULE.—Each United States citizen or resident who is an officer, director, or 10-percent shareholder of a corporation which was a foreign personal holding company (as defined in section 552) for any taxable year shall file a return with respect to such taxable year setting forth—

[(1) the shareholder information required by subsection (b),

[(2) the income information required by subsection (c), and

[(3) such other information with respect to such corporation as the Secretary shall by forms or regulations prescribe as necessary for carrying out the purposes of this title.

[(b) SHAREHOLDER INFORMATION.—The shareholder information required by this subsection with respect to any taxable year shall be—

[(1) the name and address of each person who at any time during such taxable year held any share in the corporation,

[(2) a description of each class of shares and the total number of shares of such class outstanding at the close of the taxable year,

[(3) the number of shares of each class held by each person, and

[(4) any changes in the holdings of shares during the taxable year.

For purposes of paragraphs (1), (3), and (4), the term “share” includes any security convertible into a share in the corporation and any option granted by the corporation with respect to any share in the corporation.

[(c) INCOME INFORMATION.—The income information required by this subsection for any taxable year shall be the gross income, deductions, credits, taxable income, and undistributed foreign personal holding company income of the corporation for the taxable year.

⟦(d) TIME AND MANNER FOR FURNISHING INFORMATION.—The information required under subsection (a) shall be furnished at such time and in such manner as the Secretary shall by forms and regulations prescribe.

⟦(e) DEFINITION AND SPECIAL RULES.—

⟦(1) 10-PERCENT SHAREHOLDER.—For purposes of this section, the term "10-percent shareholder" means any individual who owns directly or indirectly (within the meaning of section 554) 10 percent or more in value of the outstanding stock of a foreign corporation.

⟦(2) TIME FOR MAKING DETERMINATIONS.—

⟦(A) IN GENERAL.—Except as provided in subparagraph (B), the determination of whether any person is an officer, director, or 10-percent shareholder with respect to any foreign corporation shall be made as of the date on which the return is required to be filed.

⟦(B) SPECIAL RULE.—If after the application of subparagraph (A) no person is required to file a return under subsection (a) with respect to any foreign corporation for any taxable year, the determination of whether any person is an officer, director, or 10-percent shareholder with respect to such foreign corporation shall be made on the last day of such taxable year on which there was such a person who was a United States citizen or resident.

⟦(3) 2 OR MORE PERSONS REQUIRED TO FURNISH INFORMATION WITH RESPECT TO SAME FOREIGN CORPORATION.—If, but for this paragraph, 2 or more persons would be required to furnish information under subsection (a) with respect to the same foreign corporation for the same taxable year, the Secretary may by regulations provide that such information shall be required only from 1 person.⟧

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SEC. 6039G. INFORMATION ON INDIVIDUALS LOSING UNITED STATES CITIZENSHIP.

⟦(a) IN GENERAL.—Notwithstanding any other provision of law, any individual who loses United States citizenship (within the meaning of section 877(a) shall provide a statement which includes the information described in subsection (b). Such statement shall be—

⟦(1) provided not later than the earliest date of any act referred to in subsection (c), and

⟦(2) provided to the person or court referred to in subsection (c) with respect to such act.

⟦(b) INFORMATION TO BE PROVIDED.—Information required under subsection (a) shall include—

⟦(1) the taxpayer's TIN,

⟦(2) the mailing address of such individual's principal foreign residence,

⟦(3) the foreign country, in which such individual is residing,

⟦(4) the foreign country of which such individual is a citizen.

⟦(5) in the case of an individual having a net worth of at least the dollar amount applicable under section 877(a)(2)(B), information detailing the assets and liabilities of such individual, and

⟦(6) such other information as the Secretary may prescribe.

⟦(c) ACTS DESCRIBED.—For purposes of this section, the acts referred to in this subsection are—

⟦(1) the individual's renunciation of his United States nationality before a diplomatic or consular officer of the United States pursuant to paragraph (5) of section 349(a) of the Immigration and Nationality Act (8 U.S.C. 1481(a)(5)),

⟦(2) the individual's furnishing to the United States Department of State a signed statement of voluntary relinquishment of United States nationality confirming the performance of an act of expatriation specified in paragraph (1), (2), (3), or

⟦(4) of section 349(a) of the immigration and Nationality Act (8 U.S.C. 1481(a)(1)-(4)),

⟦(3) the issuance by the United States Department of State of a certificate of loss of nationality to the individual, or

⟦(4) the cancellation by a court of the United States of a naturalized citizen's certificate of naturalization.

⟦(d) PENALTY.—Any individual failing to provide a statement required under subsection (a) shall be subject to a penalty for each year (of the 10-year period beginning on the date of loss of United States citizenship) during any portion of which such failure continues in an amount equal to the greater of—

⟦(1) 5 percent of the tax required to be paid under section 877 for the taxable year ending during such year, or

⟦(2) $1,000,unless it is shown that such failure is due to reasonable cause and not to willful neglect.⟧

(a) IN GENERAL.—Notwithstanding any other provision of law, any individual to whom section 877(b) applies for any taxable year shall provide a statement for such taxable year which includes the information described in subsection (b).

(b) INFORMATION TO BE PROVIDED.—Information required under subsection (a) shall include—

(1) the taxpayer's TIN,

(2) the mailing address of such individual's principal foreign residence,

(3) the foreign country in which such individual is residing,

(4) the foreign country of which such individual is a citizen,

(5) information detailing the income, assets, and liabilities of such individual,

(6) the number of days during any portion of which that the individual was physically present in the United States during the taxable year, and

(7) such other information as the Secretary may prescribe.

(c) PENALTY.—If—

(1) an individual is required to file a statement under subsection (a) for any taxable year, and

(2) fails to file such a statement with the Secretary on or before the date such statement is required to be filed or fails to include all the information required to be shown on the statement or includes incorrect information,

such individual shall pay a penalty of $10,000 unless it is shown that such failure is due to reasonable cause and not to willful neglect.

[(e)] *(d)* INFORMATION TO BE PROVIDED TO SECRETARY.—Notwithstanding any other provision of law—

(1) * * *

* * * * * * *

[(f) REPORTING BY LONG-TERM LAWFUL PERMANENT RESIDENTS WHO CEASE TO BE TAXED AS RESIDENTS.—In lieu of applying the last sentence of subsection (a), any individual who is required to provide a statement under this section by reason of section 877(e)(1) shall provide such statement with the return of tax imposed by chapter 1 for the taxable year during which the event described in such section occurs.

[(g) EXEMPTION.—The Secretary may by regulations exempt any class of individuals from the requirements of this section if he determines that applying this section to such individuals is not necessary to carry out the purposes of this section.]

* * * * * * *

Subpart B—Information Concerning Transactions With Other Persons

* * * * * * *

SEC. 6043A. RETURNS RELATING TO TAXABLE MERGERS AND ACQUISITIONS.

(a) IN GENERAL.—According to the forms or regulations prescribed by the Secretary, the acquiring corporation in any taxable acquisition shall make a return setting forth—

(1) a description of the acquisition,

(2) the name and address of each shareholder of the acquired corporation who is required to recognize gain (if any) as a result of the acquisition,

(3) the amount of money and the fair market value of other property transferred to each such shareholder as part of such acquisition, and

(4) such other information as the Secretary may prescribe.

To the extent provided by the Secretary, the requirements of this section applicable to the acquiring corporation shall be applicable to the acquired corporation and not to the acquiring corporation.

(b) NOMINEES.—According to the forms or regulations prescribed by the Secretary—

(1) REPORTING.—Any person who holds stock as a nominee for another person shall furnish in the manner prescribed by the Secretary to such other person the information provided by the corporation under subsection (d).

(2) REPORTING TO NOMINEES.—In the case of stock held by any person as a nominee, references in this section (other than in subsection (c)) to a shareholder shall be treated as a reference to the nominee.

(c) TAXABLE ACQUISITION.—For purposes of this section, the term "taxable acquisition" means any acquisition by a corporation of stock in or property of another corporation if any shareholder of the

acquired corporation is required to recognize gain (if any) as a result of such acquisition.

(d) STATEMENTS TO BE FURNISHED TO SHAREHOLDERS.—According to the forms or regulations prescribed by the Secretary, every person required to make a return under subsection (a) shall 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 such return with respect to such shareholder, and

(3) such other information as the Secretary may prescribe.

The written statement required under the preceding sentence shall be furnished to the shareholder on or before January 31 of the year following the calendar year during which the taxable acquisition occurred.

* * * * * * *

Subpart C—Information Regarding Wages Paid Employees

* * * * * * *

SEC. 6051. RECEIPTS FOR EMPLOYEES,

(a) REQUIREMENT.—Every person required to deduct and withhold from an employee a tax under section 3101 or 3402, or who would have been required to deduct and withhold a tax under section 3402 (determined without regard to subsection (n)) if the employee had claimed no more than one withholding exemption, or every employer engaged in a trade or business who pays remuneration for services performed by an employee, including the cash value of such remuneration paid in any medium other than cash, shall furnish to each such employee in respect of the remuneration paid by such person to such employee during the calendar year, on or before January 31 of the succeeding year, or, if his employment is terminated before the close of such calendar year, within 30 days after the date of receipt of a written request from the employee if such 30-day period ends before January 31, a written statement showing the following:

(1) * * *

* * * * * * *

(10) in the case of an employee who is a member of the Armed Forces of the United States, such employee's earned income as determined for purposes of section 32 (relating to earned income credit), **[**and**]**

(11) the amount contributed to any Archer MSA (as defined in section 220(d) of such employee or such employee's spouse**[**.**]**, *and*

(12) the total amount of deferrals under a nonqualified deferred compensation plan (within the meaning of section 409A(d)).

In the case of compensation paid for service as a member of a uniformed service, the statement shall show, in lieu of the amount required to be shown by paragraph (5), the total amount of wages as defined in section 3121(a), computed in accordance with such section and section 3121(i)(2). In the case of compensation paid for service as a volunteer or volunteer leader within the meaning of the Peace Corps Act, the statement shall show, in lieu of the amount required to be shown by paragraph (5), the total amount of wages as defined in section 3121(a), computed in accordance with such section and section 3121(i)(3). In the case of tips received by an employee in the course of his employment, the amounts required to be shown by paragraphs (3) and (5) shall include only such tips as are included in statements furnished to the employer pursuant to section 6053(a). The amounts required to be shown by paragraph (5) shall not include wages which are exempted pursuant to sections 3101(c) and 3111(c) from the taxes imposed by sections 3101 and 3111. *In the case of the amounts required to be shown by paragraph (12), the Secretary (by regulation) may establish a minimum amount of deferrals below which paragraph (12) does not apply and may provide that paragraph (12) does not apply with respect to amounts of deferrals which are not reasonably ascertainable.*

* * * * * * *

Subchapter B—Miscellaneous Provisions

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SEC. 6103. CONFIDENTIALITY AND DISCLOSURE OF RETURNS AND RETURN INFORMATION.

(a) * * *

* * * * * * *

(e) DISCLOSURE TO PERSONS HAVING MATERIAL INTEREST.—

(1) IN GENERAL.—The return of a person shall, upon written request, be open to inspection by or disclosure to—

(A) * * *

* * * * * * *

(D) in the case of the return of a corporation or a subsidiary thereof—

(i) * * *

* * * * * * *

[(iv) if the corporation was a foreign personal holding company, as defined by section 552, any person who was a shareholder during any part of a period covered by such return if with respect to that period, or any part thereof, such shareholder was required under section 551 to include in his gross income undistributed foreign personal holding company income of such company,]

[(v)] *(iv)* if the corporation was an S corporation, any person who was a shareholder during any part of the period covered by such return during which an election under section 1362(a) was in effect, or

⟦(vi)⟧ *(v)* if the corporation has been dissolved, any person authorized by applicable State law to act for the corporation or any person who the Secretary finds to have a material interest which will be affected by information contained therein;

* * * * * * *

⟦SEC. 6111. REGISTRATION OF TAX SHELTERS.

⟦(a) REGISTRATION.—

⟦(1) IN GENERAL.—Any tax shelter organizer shall register the tax shelter with the Secretary (in such form and in such manner as the Secretary may prescribe) not later than the day on which the first offering for sale of interests in such tax shelter occurs.

⟦(2) INFORMATION INCLUDED IN REGISTRATION.—Any registration under paragraph (1) shall include—

⟦(A) information identifying and describing the tax shelter,

⟦(B) information describing the tax benefits of the tax shelter represented (or to be represented) to investors, and

⟦(C) such other information as the Secretary may prescribe.

⟦(b) FURNISHING OF TAX SHELTER IDENTIFICATION NUMBER; INCLUSION ON RETURN.—

⟦(1) SELLERS, ETC.—Any person who sells (or otherwise transfers) an interest in a tax shelter shall (at such times and in such manner as the Secretary shall prescribe) furnish to each investor who purchases (or otherwise acquires) an interest in such tax shelter from such person the identification number assigned by the Secretary to such tax shelter.

⟦(2) INCLUSION OF NUMBER ON RETURN.—Any person claiming any deduction, credit, or other tax benefit by reason of a tax shelter shall include (in such manner as the Secretary may prescribe) on the return of tax on which such deduction, credit, or other benefit is claimed the identification number assigned by the Secretary to such tax shelter.

⟦(c) TAX SHELTER.—For purposes of this section—

⟦(1) IN GENERAL.—The term "tax shelter" means any investment—

⟦(A) with respect to which any person could reasonably infer from the representations made, or to be made, in connection with the offering for sale of interests in the investment that the tax shelter ratio for any investor as of the close of any of the first 5 years ending after the date on which such investment is offered for sale may be greater than 2 to 1, and

⟦(B) which is—

⟦(i) required to be registered under a Federal or State law regulating securities,

⟦(ii) sold pursuant to an exemption from registration requiring the filing of a notice with a Federal or State agency regulating the offering or sale of securities, or

⟦(iii) a substantial investment.

⟦(2) TAX SHELTER RATIO DEFINED.—For purposes of this subsection, the term "tax shelter ratio" means, with respect to any year, the ratio which—

⟦(A) the aggregate amount of the deductions and 350 percent of the credits which are represented to be potentially allowable to any investor under subtitle A for all periods up to (and including) the close of such year, bears to

⟦(B) the investment base as of the close of such year.

⟦(3) INVESTMENT BASE.—

⟦(A) IN GENERAL.—Except as provided in this paragraph, the term "investment base" means, with respect to any year, the amount of money and the adjusted basis of other property (reduced by any liability to which such other property is subject) contributed by the investor as of the close of such year.

⟦(B) CERTAIN BORROWED AMOUNTS EXCLUDED.—For purposes of subparagraph (A), there shall not be taken into account any amount borrowed from any person—

⟦(i) who participated in the organization, sale, or management of the investment, or

⟦(ii) who is a related person (as defined in section 465(b)(3)(C)) to any person described in clause (i),unless such amount is unconditionally required to be repaid by the investor before the close of the year for which the determination is being made.

⟦(C) CERTAIN OTHER AMOUNTS INCLUDED OR EXCLUDED.—

⟦(i) AMOUNTS HELD IN CASH EQUIVALENTS, ETC.—No amount shall be taken into account under subparagraph (A) which is to be held in cash equivalent or marketable securities.

⟦(ii) AMOUNTS INCLUDED OR EXCLUDED BY SECRETARY.—The Secretary may by regulation—

⟦(I) exclude from the investment base any amount described in subparagraph (A), or

⟦(II) include in the investment base any amount not described in subparagraph (A),if the Secretary determines that such exclusion or inclusion is necessary to carry out the purposes of this section.

⟦(4) SUBSTANTIAL INVESTMENT.—An investment is a substantial investment if—

⟦(A) the aggregate amount which may be offered for sale exceeds $250,000, and

⟦(B) there are expected to be 5 or more investors.

⟦(d) CERTAIN CONFIDENTIAL ARRANGEMENTS TREATED AS TAX SHELTERS.—

⟦(1) IN GENERAL.—For purposes of this section, the term "tax shelter" includes any entity, plan, arrangement, or transaction—

⟦(A) a significant purpose of the structure of which is the avoidance or evasion of Federal income tax for a direct or indirect participant which is a corporation,

⟦(B) which is offered to any potential participant under conditions of confidentiality, and

⟦(C) for which the tax shelter promoters may receive fees in excess of $100,000 in the aggregate.

⟦(2) CONDITIONS OF CONFIDENTIALITY.—For purposes of paragraph (1)(B), an offer is under conditions of confidentiality if—

⟦(A) the potential participant to whom the offer is made (or any other person acting on behalf of such participant) has an understanding or agreement with or for the benefit of any promoter of the tax shelter that such participant (or such other person) will limit disclosure of the tax shelter or any significant tax features of the tax shelter, or

⟦(B) any promoter of the tax shelter—

⟦(i) claims, knows, or has reason to know,

⟦(ii) knows or has reason to know that any other person (other than the potential participant) claims, or

⟦(iii) causes another person to claim,that the tax shelter (or any aspect thereof) is proprietary to any person other than the potential participant or is otherwise protected from disclosure to or use by others.

For purposes of this subsection, the term "promoter" means any person or any related person (within the meaning of section 267 or 707) who participates in the organization, management, or sale of the tax shelter.

⟦(3) PERSONS OTHER THAN PROMOTER REQUIRED TO REGISTER IN CERTAIN CASES.—

⟦(A) IN GENERAL.—If—

⟦(i) the requirements of subsection (a) are not met with respect to any tax shelter (as defined in paragraph (1)) by any tax shelter promoter, and

⟦(ii) no tax shelter promoter is a United States person,then each United States person who discussed participation in such shelter shall register such shelter under subsection (a).

⟦(B) EXCEPTION.—Subparagraph (A) shall not apply to a United States person who discussed participation in a tax shelter if—

⟦(i) such person notified the promoter in writing (not later than the close of the 90th day after the day on which such discussions began) that such person would not participate in such shelter, and

⟦(ii) such person does not participate in such shelter.

⟦(4) OFFER TO PARTICIPATE TREATED AS OFFER FOR SALE.—For purposes of subsections (a) and (b), an offer to participate in a tax shelter (as defined in paragraph (1)) shall be treated as an offer for sale.

⟦(e) OTHER DEFINITIONS.—For purposes of this section—

⟦(1) TAX SHELTER ORGANIZER.—The term "tax shelter organizer" means—

⟦(A) the person principally responsible for organizing the tax shelter,

⟦(B) if the requirements of subsection (a) are not met by a person described in subparagraph (A) at the time prescribed therefor, any other person who participated in the organization of the tax shelter, and

⟦(C) if the requirements of subsection (a) are not met by a person described in subparagraph (A) or (B) at the time prescribed therefor, any person participating in the sale or management of the investment at a time when the tax shelter was not registered under subsection (a).

⟦(2) YEAR.—The term "year" means—

⟦(A) the taxable year of the tax shelter, or

⟦(B) if the tax shelter has no taxable year, the calendar year.

⟦(f) REGULATIONS.—The Secretary may prescribe regulations which provide—

⟦(1) rules for the aggregation of similar investments offered by the same person or persons for purposes of applying subsection (c)(4),

⟦(2) that only 1 person shall be required to meet the requirements of subsection (a) in cases in which 2 or more persons would otherwise be required to meet such requirements,

⟦(3) exemptions from the requirements of this section, and

⟦(4) such rules as may be necessary or appropriate to carry out the purposes of this section in the case of foreign tax shelters.

⟦SEC. 6112. ORGANIZERS AND SELLERS OF POTENTIALLY ABUSIVE TAX SHELTERS MUST KEEP LISTS OF INVESTORS.

⟦(a) IN GENERAL.—Any person who—

⟦(1) organizes any potentially abusive tax shelter, or

⟦(2) sells any interest in such a shelter,shall maintain (in such manner as the Secretary may by regulations prescribe) a list identifying each person who was sold an interest in such shelter and containing such other information as the Secretary may by regulations require.

⟦(b) POTENTIALLY ABUSIVE TAX SHELTER.—For purposes of this section, the term "potentially abusive tax shelter" means—

⟦(1) any tax shelter (as defined in section 6111) with respect to which registration is required under section 6111, and

⟦(2) any entity, investment plan or arrangement, or other plan or arrangement which is of a type which the Secretary determines by regulations as having a potential for tax avoidance or evasion.⟧

SEC. 6111. DISCLOSURE OF REPORTABLE TRANSACTIONS.

(a) IN GENERAL.—Each material advisor with respect to any reportable transaction shall make a return (in such form as the Secretary may prescribe) setting forth—

(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.

Such return shall be filed not later than the date specified by the Secretary.

(b) DEFINITIONS.—For purposes of this section—

(1) MATERIAL ADVISOR.—

(A) IN GENERAL.—The term "material advisor" means any person—

(i) who provides any material aid, assistance, or advice with respect to organizing, managing, promoting,

selling, implementing, or carrying out any reportable transaction, and

(ii) who directly or indirectly derives gross income in excess of the threshold amount (or such other amount as may be prescribed by the Secretary) for such advice or assistance.

(B) THRESHOLD AMOUNT.—For purposes of subparagraph (A), the threshold amount is—

(i) $50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons, and

(ii) $250,000 in any other case.

(2) REPORTABLE TRANSACTION.—The term "reportable transaction" has the meaning given to such term by section 6707A(c).

(c) REGULATIONS.—The Secretary may prescribe regulations which provide—

(1) that only 1 person shall be required to meet the requirements of subsection (a) in cases in which 2 or more persons would otherwise be required to meet such requirements,

(2) exemptions from the requirements of this section, and

(3) such rules as may be necessary or appropriate to carry out the purposes of this section.

SEC. 6112. MATERIAL ADVISORS OF REPORTABLE TRANSACTIONS MUST KEEP LISTS OF ADVISEES, ETC.

(a) IN GENERAL.—Each material advisor (as defined in section 6111) with respect to any reportable transaction (as defined in section 6707A(c)) shall (whether or not required to file a return under section 6111 with respect to such transaction) maintain (in such manner as the Secretary may by regulations prescribe) a list—

(1) identifying each person with respect to whom such advisor acted as a material advisor with respect to such transaction, and

(2) containing such other information as the Secretary may by regulations require.

[(c)] *(b)* SPECIAL RULES.—

(1) AVAILABILITY FOR INSPECTION; RETENTION OF INFORMATION ON LIST.—Any person who is required to maintain a list under subsection (a)—

(A) shall make such list available to the Secretary for inspection upon *written* request by the Secretary, and

(B) except as otherwise provided under regulations prescribed by the Secretary, shall retain any information which is required to be included on such list for 7 years.

For purposes of this section, the identity of any person on such list shall not be privileged.

(2) LISTS WHICH WOULD BE REQUIRED TO BE MAINTAINED BY 2 OR MORE PERSONS.—The Secretary [shall] *may* prescribe regulations which provide that, in cases in which 2 or more persons are required under subsection (a) to maintain the same list (or portion thereof), only 1 person shall be required to maintain such list (or portion).

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CHAPTER 62—TIME AND PLACE FOR PAYING TAX

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Subchapter A—Place and Due Date for Payment of Tax

* * * * * * *

SEC. 6159. AGREEMENTS FOR PAYMENT OF TAX LIABILITY IN INSTALLMENTS.

(a) AUTHORIZATION OF AGREEMENTS.—The Secretary is authorized to enter into written agreements with any taxpayer under which such taxpayer is allowed to ⟦satisfy liability for payment of⟧ *make payment on* any tax in installment payments if the Secretary determines that such agreement will facilitate *full or partial* collection of such liability.

* * * * * * *

(c) SECRETARY REQUIRED TO ENTER INTO INSTALLMENT AGREEMENTS IN CERTAIN CASES.—In the case of a liability for tax of an individual under subtitle A, the Secretary shall enter into an agreement to accept the *full* payment of such tax in installments if, as of the date the individual offers to enter into the agreement—

(1) * * *

* * * * * * *

(d) SECRETARY REQUIRED TO REVIEW INSTALLMENT AGREEMENTS FOR PARTIAL COLLECTION EVERY TWO YEARS.—In the case of an agreement entered into by the Secretary under subsection (a) for partial collection of a tax liability, the Secretary shall review the agreement at least once every 2 years.

⟦(d)⟧ *(e)* ADMINISTRATIVE REVIEW.—The Secretary shall establish procedures for an independent administrative review of terminations of installment agreements under this section for taxpayers who request such a review.

⟦(e)⟧ *(f)* CROSS REFERENCE.—

For rights to administrative review and appeal, see section 7122(d).

CHAPTER 66—LIMITATIONS

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Subchapter A—Limitations on Assessment and Collection

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SEC. 6501. LIMITATIONS ON ASSESSMENT AND COLLECTION.

(a) * * *

* * * * * * *

(c) EXCEPTIONS.—

(1) * * *

* * * * * * *

(10) LISTED TRANSACTIONS.—If a taxpayer fails to include on any return or statement for any taxable year any information with respect to a listed transaction (as defined in section 6707A(c)(2)) which is required under section 6011 to be included with such return or statement, the time for assessment of any tax imposed by this title with respect to such transaction shall not expire before the date which is 1 year after the earlier of—

(A) the date on which the Secretary is furnished the information so required, or

(B) the date that a material advisor (as defined in section 6111) meets the requirements of section 6112 with respect to a request by the Secretary under section 6112(b) relating to such transaction with respect to such taxpayer.

* * * * * * *

(e) SUBSTANTIAL OMISSION OF ITEMS.—Except as otherwise provided in subsection (c)—

(1) INCOME TAXES.—In the case of any tax imposed by subtitle A—

(A) * * *

[(B) CONSTRUCTIVE DIVIDENDS.—If the taxpayer omits from gross income an amount properly includible therein under section 551(b) (relating to the inclusion in the gross income of United States shareholders of their distributive shares of the undistributed foreign personal holding company income), the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return was filed.]

(B) CONSTRUCTIVE DIVIDENDS.—If the taxpayer omits from gross income an amount properly includible therein under section 951(a), the tax may be assessed, or a proceeding in court for the collection of such tax may be done without assessing, at any time within 6 years after the return was filed.

* * * * * * *

CHAPTER 67—INTEREST

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Subchapter A—Interest on Underpayments

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SEC. 6603. DEPOSITS MADE TO SUSPEND RUNNING OF INTEREST ON POTENTIAL UNDERPAYMENTS, ETC.

(a) AUTHORITY TO MAKE DEPOSITS OTHER THAN AS PAYMENT OF TAX.—A taxpayer may make a cash deposit with the Secretary which may be used by the Secretary to pay any tax imposed under subtitle A or B or chapter 41, 42, 43, or 44 which has not been assessed at the time of the deposit. Such a deposit shall be made in such manner as the Secretary shall prescribe.

(b) NO INTEREST IMPOSED.—To the extent that such deposit is used by the Secretary to pay tax, for purposes of section 6601 (relating to interest on underpayments), the tax shall be treated as paid when the deposit is made.

(c) RETURN OF DEPOSIT.—Except in a case where the Secretary determines that collection of tax is in jeopardy, the Secretary shall return to the taxpayer any amount of the deposit (to the extent not used for a payment of tax) which the taxpayer requests in writing.

(d) PAYMENT OF INTEREST.—

(1) IN GENERAL.—For purposes of section 6611 (relating to interest on overpayments), a deposit which is returned to a taxpayer shall be treated as a payment of tax for any period to the extent (and only to the extent) attributable to a disputable tax for such period. Under regulations prescribed by the Secretary, rules similar to the rules of section 6611(b)(2) shall apply.

(2) DISPUTABLE TAX.—

(A) IN GENERAL.—For purposes of this section, the term "disputable tax" means the amount of tax specified at the time of the deposit as the taxpayer's reasonable estimate of the maximum amount of any tax attributable to disputable items.

(B) SAFE HARBOR BASED ON 30-DAY LETTER.—In the case of a taxpayer who has been issued a 30-day letter, the maximum amount of tax under subparagraph (A) shall not be less than the amount of the proposed deficiency specified in such letter.

(3) OTHER DEFINITIONS.—For purposes of paragraph (2)—

(A) DISPUTABLE ITEM.—The term "disputable item" means any item of income, gain, loss, deduction, or credit if the taxpayer—

(i) has a reasonable basis for its treatment of such item, and

(ii) reasonably believes that the Secretary also has a reasonable basis for disallowing the taxpayer's treatment of such item.

(B) 30-DAY LETTER.—The term "30-day letter" means the first letter of proposed deficiency which allows the taxpayer an opportunity for administrative review in the Internal Revenue Service Office of Appeals.

(4) RATE OF INTEREST.—The rate of interest allowable under this subsection shall be the Federal short-term rate determined under section 6621(b), compounded daily.

(e) USE OF DEPOSITS.—

(1) PAYMENT OF TAX.—Except as otherwise provided by the taxpayer, deposits shall be treated as used for the payment of tax in the order deposited.

(2) RETURNS OF DEPOSITS.—Deposits shall be treated as returned to the taxpayer on a last-in, first-out basis.

* * * * * * *

CHAPTER 68—ADDITIONS TO THE TAX, ADDITIONAL AMOUNTS, AND ASSESSABLE PENALTIES

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Subchapter A—Additions to the Tax and Additional Amounts

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PART II—ACCURACY-RELATED AND FRAUD PENALTIES

* * * * * * *

[SEC. 6662. IMPOSITION OF ACCURACY-RELATED PENALTY.]

SEC. 6662. IMPOSITION OF ACCURACY-RELATED PENALTY ON UNDERPAYMENTS.

(a) * * *

* * * * * * *

(d) SUBSTANTIAL UNDERSTATEMENT OF INCOME TAX.—

(1) SUBSTANTIAL UNDERSTATEMENT.—

(A) * * *

[(B) SPECIAL RULE FOR CORPORATIONS.—In the case of a corporation other than an S corporation or a personal holding company (as defined in section 542), paragraph (1) shall be applied by substituting "$10,000" for "$5,000".]

(B) SPECIAL RULE FOR CORPORATIONS.—In the case of a corporation other than an S corporation or a personal holding company (as defined in section 542), there is a substantial understatement of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the lesser of—

(i) 10 percent of the tax required to be shown on the return for the taxable year (or, if greater, $10,000), or

(ii) $10,000,000.

(2) UNDERSTATEMENT.—

(A) IN GENERAL.—For purposes of paragraph (1), the term "understatement" means the excess of—

(i) * * *

* * * * * * *

The excess under the preceding sentence shall be determined without regard to items to which section 6662A applies.

* * * * * * *

⟦(C) SPECIAL RULES IN CASES INVOLVING TAX SHELTERS.—

⟦(i) IN GENERAL.—In the case of any item of a taxpayer other than a corporation which is attributable to a tax shelter—

⟦(I) subparagraph (B)(ii) shall not apply, and

⟦(II) subparagraph (B)(i) shall not apply unless (in addition to meeting the requirements of such subparagraph) the taxpayer reasonably believed that the tax treatment of such item by the taxpayer was more likely than not the proper treatment.

⟦(ii) SUBPARAGRAPH (B) NOT TO APPLY TO CORPORATIONS.—Subparagraph (B) shall not apply to any item of a corporation which is attributable to a tax shelter.

⟦(iii) TAX SHELTER.—For purposes of this subparagraph, the term "tax shelter" means—

⟦(I) a partnership or other entity,

⟦(II) any investment plan or arrangement, or

⟦(III) any other plan or arrangement,

if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.⟧

(C) REDUCTION NOT TO APPLY TO TAX SHELTERS.—

(i) IN GENERAL.—Subparagraph (B) shall not apply to any item attributable to a tax shelter.

(ii) TAX SHELTER.—For purposes of clause (i), the term "tax shelter" means—

(I) a partnership or other entity,

(II) any investment plan or arrangement, or

(III) any other plan or arrangement,

if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.

* * * * * * *

SEC. 6662A. IMPOSITION OF ACCURACY-RELATED PENALTY ON UNDERSTATEMENTS WITH RESPECT TO REPORTABLE TRANSACTIONS.

(a) IMPOSITION OF PENALTY.—If a taxpayer has a reportable transaction understatement for any taxable year, there shall be added to the tax an amount equal to 20 percent of the amount of such understatement.

(b) REPORTABLE TRANSACTION UNDERSTATEMENT.—For purposes of this section—

(1) IN GENERAL.—The term "reportable transaction understatement" means the sum of—

(A) the product of—

(i) the amount of the increase (if any) in taxable income which results from a difference between the proper tax treatment of an item to which this section ap-

plies and the taxpayer's treatment of such item (as shown on the taxpayer's return of tax), and

(ii) the highest rate of tax imposed by section 1 (section 11 in the case of a taxpayer which is a corporation), and

(B) the amount of the decrease (if any) in the aggregate amount of credits determined under subtitle A which results from a difference between the taxpayer's treatment of an item to which this section applies (as shown on the taxpayer's return of tax) and the proper tax treatment of such item.

For purposes of subparagraph (A), any reduction of 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.

(2) ITEMS TO WHICH SECTION APPLIES.—This section shall apply to any item which is attributable to—

(A) any listed transaction, and

(B) any reportable transaction (other than a listed transaction) if a significant purpose of such transaction is the avoidance or evasion of Federal income tax.

(c) HIGHER PENALTY FOR NONDISCLOSED TRANSACTIONS.—Subsection (a) shall be applied by substituting "30 percent" for "20 percent" with respect to the portion of any reportable transaction understatement with respect to which the requirement of section 6664(d)(2)(A) is not met.

(d) DEFINITIONS OF REPORTABLE AND LISTED TRANSACTIONS.—For purposes of this section, the terms "reportable transaction" and "listed transaction" have the respective meanings given to such terms by section 6707A(c).

(e) SPECIAL RULES.—

(1) COORDINATION WITH PENALTIES, ETC., ON OTHER UNDERSTATEMENTS.—In the case of an understatement (as defined in section 6662(d)(2))—

(A) the amount of such understatement (determined without regard to this paragraph) shall be increased by the aggregate amount of reportable transaction understatements for purposes of determining whether such understatement is a substantial understatement under section 6662(d)(1), and

(B) the addition to tax under section 6662(a) shall apply only to the excess of the amount of the substantial understatement (if any) after the application of subparagraph (A) over the aggregate amount of reportable transaction understatements.

(2) COORDINATION WITH OTHER PENALTIES.—

(A) APPLICATION OF FRAUD PENALTY.—References to an underpayment in section 6663 shall be treated as including references to a reportable transaction understatement.

(B) NO DOUBLE PENALTY.—This section shall not apply to any portion of an understatement on which a penalty is imposed under section 6663.

(3) SPECIAL RULE FOR AMENDED RETURNS.—Except as provided in regulations, in no event shall any tax treatment in-

cluded with an amendment or supplement to a return of tax be taken into account in determining the amount of any reportable transaction understatement if the amendment or supplement is filed after the earlier of the date the taxpayer is first contacted by the Secretary regarding the examination of the return or such other date as is specified by the Secretary.

* * * * * * *

SEC. 6664. DEFINITIONS AND SPECIAL RULES.

(a) * * *

* * * * * * *

(c) REASONABLE CAUSE EXCEPTION *FOR UNDERPAYMENTS*.—

(1) IN GENERAL.—No penalty shall be imposed under ⟦this part⟧ *section 6662 or 6663* with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.

* * * * * * *

(d) REASONABLE CAUSE EXCEPTION FOR REPORTABLE TRANSACTION UNDERSTATEMENTS.—

(1) IN GENERAL.—No penalty shall be imposed under section 6662A with respect to any portion of a reportable transaction understatement if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.

(2) SPECIAL RULES.—Paragraph (1) shall not apply to any reportable transaction understatement unless—

(A) the relevant facts affecting the tax treatment of the item are adequately disclosed in accordance with the regulations prescribed under section 6011,

(B) there is or was substantial authority for such treatment, and

(C) the taxpayer reasonably believed that such treatment was more likely than not the proper treatment.

A taxpayer failing to adequately disclose in accordance with section 6011 shall be treated as meeting the requirements of subparagraph (A) if the penalty for such failure was rescinded under section 6707A(d).

(3) RULES RELATING TO REASONABLE BELIEF.—For purposes of paragraph (2)(C)—

(A) IN GENERAL.—A taxpayer shall be treated as having a reasonable belief with respect to the tax treatment of an item only if such belief—

(i) is based on the facts and law that exist at the time the return of tax which includes such tax treatment is filed, and

(ii) relates solely to the taxpayer's chances of success on the merits of such treatment and does not take into account the possibility that a return will not be audited, such treatment will not be raised on audit, or such treatment will be resolved through settlement if it is raised.

(B) CERTAIN OPINIONS MAY NOT BE RELIED UPON.—

(i) IN GENERAL.—An opinion of a tax advisor may not be relied upon to establish the reasonable belief of a taxpayer if—

(I) the tax advisor is described in clause (ii), or

(II) the opinion is described in clause (iii).

(ii) DISQUALIFIED TAX ADVISORS.—A tax advisor is described in this clause if the tax advisor—

(I) is a material advisor (within the meaning of section 6111(b)(1)) and participates in the organization, management, promotion, or sale of the transaction or is related (within the meaning of section 267(b) or 707(b)(1)) to any person who so participates,

(II) is compensated directly or indirectly by a material advisor with respect to the transaction,

(III) has a fee arrangement with respect to the transaction which is contingent on all or part of the intended tax benefits from the transaction being sustained, or

(IV) as determined under regulations prescribed by the Secretary, has a disqualifying financial interest with respect to the transaction.

(iii) DISQUALIFIED OPINIONS.—For purposes of clause (i), an opinion is disqualified if the opinion—

(I) is based on unreasonable factual or legal assumptions (including assumptions as to future events),

(II) unreasonably relies on representations, statements, findings, or agreements of the taxpayer or any other person,

(III) does not identify and consider all relevant facts, or

(IV) fails to meet any other requirement as the Secretary may prescribe.

Subchapter B—Assessable Penalties

* * * * * * *

PART I—GENERAL PROVISIONS

* * * * * * *

SEC. 6679. FAILURE TO FILE RETURNS, ETC., WITH RESPECT TO FOREIGN CORPORATIONS OR FOREIGN PARTNERSHIPS.

(a) CIVIL PENALTY.—

(1) IN GENERAL.—In addition to any criminal penalty provided by law, any person required to file a return under section [6035, 6046, or 6046A] *6046 or 6046A* who fails to file such return at the time provided in such section, or who files a return which does not show the information required pursuant to such section, shall pay a penalty of $10,000, unless it is shown that such failure is due to reasonable cause.

* * * * * * *

[(3) REDUCED PENALTY FOR RETURNS RELATING TO FOREIGN PERSONAL HOLDING COMPANIES.—In the case of a return required under section 6035, paragraph (1) shall be applied by substituting "$1,000" for "$10,000", and paragraph (2) shall not apply.]

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SEC. 6700. PROMOTING ABUSIVE TAX SHELTERS, ETC.

(a) IMPOSITION OF PENALTY.—Any person who—

(1) * * *

* * * * * * *

Notwithstanding the first sentence, if an activity with respect to which a penalty imposed under this subsection involves a statement described in paragraph (2)(A), the amount of the penalty shall be equal to 50 percent of the gross income derived (or to be derived) from such activity by the person on which the penalty is imposed.

* * * * * * *

[SEC. 6707. FAILURE TO FURNISH INFORMATION REGARDING TAX SHELTERS.

[(a) FAILURE TO REGISTER TAX SHELTER.—

[(1) IMPOSITION OF PENALTY.—If a person who is required to register a tax shelter under section 6111(a)—

[(A) fails to register such tax shelter on or before the date described in section 6111(a)(1), or

[(B) files false or incomplete information with the Secretary with respect to such registration,

such person shall pay a penalty with respect to such registration in the amount determined under paragraph (2). No penalty shall be imposed under the preceding sentence with respect to any failure which is due to reasonable cause.

[(2) AMOUNT OF PENALTY.—Except as provided in paragraph (3), the penalty imposed under paragraph (1) with respect to any tax shelter shall be an amount equal to the greater of—

[(A) 1 percent of the aggregate amount invested in such tax shelter, or

[(B) $500.

[(3) CONFIDENTIAL ARRANGEMENTS.—

[(A) IN GENERAL.—In the case of a tax shelter (as defined in section 6111(d)), the penalty imposed under paragraph (1) shall be an amount equal to the greater of—

[(i) 50 percent of the fees paid to all promoters of the tax shelter with respect to offerings made before the date such shelter is registered under section 6111, or

[(ii) $10,000.

Clause (i) shall be applied by substituting "75 percent" for "50 percent" in the case of an intentional failure or act described in paragraph (1).

[(B) SPECIAL RULE FOR PARTICIPANTS REQUIRED TO REGISTER SHELTER.—In the case of a person required to register such a tax shelter by reason of section 6111(d)(3)—

[(i) such person shall be required to pay the penalty under paragraph (1) only if such person actually participated in such shelter,

[(ii) the amount of such penalty shall be determined by taking into account under subparagraph (A)(i) only the fees paid by such person, and

[(iii) such penalty shall be in addition to the penalty imposed on any other person for failing to register such shelter.

[(b) FAILURE TO FURNISH TAX SHELTER IDENTIFICATION NUMBER.—

[(1) SELLERS, ETC.—Any person who fails to furnish the identification number of a tax shelter which such person is required to furnish under section 6111(b)(1) shall pay a penalty of $100 for each such failure.

[(2) FAILURE TO INCLUDE NUMBER ON RETURN.—Any person who fails to include an identification number on a return on which such number is required to be included under section 6111(b)(2) shall pay a penalty of $250 for each such failure, unless such failure is due to reasonable cause.]

SEC. 6707. FAILURE TO FURNISH INFORMATION REGARDING REPORTABLE TRANSACTIONS.

(a) IN GENERAL.—If a person who is required to file a return under section 6111(a) with respect to any reportable transaction—

(1) fails to file such return on or before the date prescribed therefor, or

(2) files false or incomplete information with the Secretary with respect to such transaction,

such person shall pay a penalty with respect to such return in the amount determined under subsection (b).

(b) AMOUNT OF PENALTY.—

(1) IN GENERAL.—Except as provided in paragraph (2), the penalty imposed under subsection (a) with respect to any failure shall be $50,000.

(2) LISTED TRANSACTIONS.—The penalty imposed under subsection (a) with respect to any listed transaction shall be an amount equal to the greater of—

(A) $200,000, or

(B) 50 percent of the gross income derived by such person with respect to aid, assistance, or advice which is provided with respect to the listed transaction before the date the return is filed under section 6111.

Subparagraph (B) shall be applied by substituting "75 percent" for "50 percent" in the case of an intentional failure or act described in subsection (a).

(c) RESCISSION AUTHORITY.—The provisions of section 6707A(d) (relating to authority of Commissioner to rescind penalty) shall apply to any penalty imposed under this section.

(d) REPORTABLE AND LISTED TRANSACTIONS.—For purposes of this section, the terms "reportable transaction" and "listed transaction" have the respective meanings given to such terms by section 6707A(c).

SEC. 6707A. PENALTY FOR FAILURE TO INCLUDE REPORTABLE TRANSACTION INFORMATION WITH RETURN.

(a) IMPOSITION OF PENALTY.—Any person who fails to include on any return or statement any information with respect to a reportable transaction which is required under section 6011 to be included with such return or statement shall pay a penalty in the amount determined under subsection (b).

(b) AMOUNT OF PENALTY.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amount of the penalty under subsection (a) shall be—

(A) $10,000 in the case of a natural person, and

(B) $50,000 in any other case.

(2) LISTED TRANSACTION.—The amount of the penalty under subsection (a) with respect to a listed transaction shall be—

(A) $100,000 in the case of a natural person, and

(B) $200,000 in any other case.

(c) DEFINITIONS.—For purposes of this section—

(1) REPORTABLE TRANSACTION.—The term "reportable transaction" means any transaction with respect to which information is required to be included with a return or statement because, as determined under regulations prescribed under section 6011, such transaction is of a type which the Secretary determines as having a potential for tax avoidance or evasion.

(2) LISTED TRANSACTION.—The term "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.

(d) AUTHORITY TO RESCIND PENALTY.—

(1) IN GENERAL.—The Commissioner of Internal Revenue may rescind all or any portion of any penalty imposed by this section with respect to any violation if—

(A) the violation is with respect to a reportable transaction other than a listed transaction, and

(B) rescinding the penalty would promote compliance with the requirements of this title and effective tax administration.

(2) NO JUDICIAL APPEAL.—Notwithstanding any other provision of law, any determination under this subsection may not be reviewed in any judicial proceeding.

(3) RECORDS.—If a penalty is rescinded under paragraph (1), the Commissioner shall place in the file in the Office of the Commissioner the opinion of the Commissioner or the head of the Office of Tax Shelter Analysis with respect to the determination, including—

(A) a statement of the facts and circumstances relating to the violation,

(B) the reasons for the rescission, and

(C) the amount of the penalty rescinded.

(e) COORDINATION WITH OTHER PENALTIES.—The penalty imposed by this section shall be in addition to any other penalty imposed by this title.

[SEC. 6708. FAILURE TO MAINTAIN LISTS OF INVESTORS IN POTENTIALLY ABUSIVE TAX SHELTERS.

[(a) IN GENERAL.—Any person who fails to meet any requirement imposed by section 6112 shall pay a penalty of $50 for each person with respect to whom there is such a failure, unless it is shown that such failure is due to reasonable cause and not due to willful neglect. The maximum penalty imposed under this subsection for any calendar year shall not exceed $100,000.]

SEC. 6708. FAILURE TO MAINTAIN LISTS OF ADVISEES WITH RESPECT TO REPORTABLE TRANSACTIONS.

(a) IMPOSITION OF PENALTY.—

(1) IN GENERAL.—If any person who is required to maintain a list under section 6112(a) fails to make such list available upon written request to the Secretary in accordance with section 6112(b) within 20 business days after the date of such request, such person shall pay a penalty of $10,000 for each day of such failure after such 20th day.

(2) REASONABLE CAUSE EXCEPTION.—No penalty shall be imposed by paragraph (1) with respect to the failure on any day if such failure is due to reasonable cause.

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PART II—FAILURE TO COMPLY WITH CERTIAN INFORMATION REPORTING REQUIREMENTS

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SEC. 6724. WAIVER; DEFINITIONS AND SPECIAL RULES.

(a) * * *

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(d) DEFINITIONS.—For purposes of this part—

(1) INFORMATION RETURN.—The term "information return" means—

(A) * * *

(B) any return required by—

(i) section 6041A(a) or (b) (relating to returns of direct sellers),

(ii) section 6043A(a) (relating to returns relating to taxable mergers and acquisitions),

[(ii)] *(iii)* section 6045(a) or (d) (relating to returns of brokers),

[(iii)] *(iv)* section 6050H(a) (relating to mortgage interest received in trade or business from individuals),

[(iv)] *(v)* section 6050I(a) or (g)(1) (relating to cash received in trade or business, etc.),

[(v)] *(vi)* section 6050J(a) (relating to foreclosures and abandonments of security),

[(vi)] *(vii)* section 6050K(a) (relating to exchanges of certain partnership interests),

[(vii)] *(viii)* section 6050L(a) (relating to returns relating to certain dispositions of donated property),

⟦(viii)⟧ *(ix)* section 6050P (relating to returns relating to the cancellation of indebtedness by certain financial entities),

⟦(ix)⟧ *(x)* section 6050S (relating to returns relating to payments for qualified tuition and related expenses),

⟦(x)⟧ *(xi)* section 6050S (relating to returns relating to payments for qualified tuition and related expenses),

⟦(xi)⟧ *(xii)* section 6050T (relating to returns relating to credit for health insurance costs of eligible individuals),

⟦(xii)⟧ *(xiii)* section 6052(a) (relating to reporting payment of wages in the form of term-life insurance),

⟦(xiii)⟧ *(xiv)* section 6053(c)(1) (relating to reporting with respect to certain tips),

⟦(xiv)⟧ *(xv)* subsection (b) or (e) of section 1060 (relating to reporting requirements of transferors and transferees in certain asset acquisitions),

⟦(xv)⟧ *(xvi)* subparagraph (A) or (C) of subsection (c)(4) of section 4093 (relating to information reporting with respect to tax on diesel and aviation fuels),

⟦(xvi)⟧ *(xvii)* section 4101(d) (relating to information reporting with respect to fuels taxes),

⟦(xvii)⟧ *(xviii)* subparagraph (C) of section 338(h)(10) (relating to information required to be furnished to the Secretary in case of elective recognition of gain or loss), or

⟦(xviii)⟧ *(xix)* ssection 264(f)(5)(A)(iv) (relating to reporting with respect to certain life insurance and annuity contracts), and

(2) PAYEE STATEMENT.—The term "payee statement" means any statement required to be furnished under—

(A) * * *

* * * * * * *

(F) subsections (b) and (d) of section 6043A (relating to returns relating to taxable mergers and acquisitions).

⟦(F)⟧ *(G)* section 6044(e) (relating to returns regarding payments of patronage dividends),

⟦(G)⟧ *(H)* section 6045(b) or (d) (relating to returns of brokers),

⟦(H)⟧ *(I)* section 6049(c) (relating to returns regarding payments of interest),

⟦(I)⟧ *(J)* section 6050A(b) (relating to reporting requirements of certain fishing boat operators),

⟦(J)⟧ *(K)* section 6050H(d) (relating to returns relating to mortgage interest received in trade or business from individuals),

⟦(K)⟧ *(L)* section 6050I(e) or paragraph (4) or (5) of section 6050I(g) (relating to cash received in trade or business, etc.),

⟦(L)⟧ *(M)* section 6050J(e) (relating to returns relating to foreclosures and abandonments of security),

⟦(M)⟧ *(N)* section 6050K(b) (relating to returns relating to exchanges of certain partnership interests),

⟦(N)⟧ *(O)* section 6050L(c) (relating to returns relating to certain dispositions of donated property),

⟦(O)⟧ *(P)* section 6050N(b) (relating to returns regarding payments of royalties),

⟦(P)⟧ *(Q)* section 6050P(d) (relating to returns relating to the cancellation of indebtedness by certain financial entities),

⟦(Q)⟧ *(R)* section 6050Q(b) (relating to certain long-term care benefits),

⟦(R)⟧ *(S)* section 6050R(c) (relating to returns relating to certain purchases of fish),

⟦(S)⟧ *(T)* section 6051 (relating to receipts for employees),

⟦(T)⟧ *(U)* section 6052(b) (relating to returns regarding payment of wages in the form of group-term life insurance),

⟦(U)⟧ *(V)* section 6053(b) or (c) (relating to reports of tips),

⟦(V)⟧ *(W)* section 6048(b)(1)(B) (relating to foreign trust reporting requirements),

⟦(W)⟧ *(X)* section 4093(c)(4)(B) (relating to certain purchasers of diesel and aviation fuels),

⟦(X)⟧ *(Y)* section 408(i) (relating to reports with respect to individual retirement plans) to any person other than the Secretary with respect to the amount of payments made to such person,

⟦(Y)⟧ *(Z)* section 6047(d) (relating to reports by plan administrators) to any person other than the Secretary with respect to the amount of payments made to such person,

⟦(Z)⟧ *(AA)* section 6050S(d) (relating to returns relating to qualified tuition and related expenses),

⟦(AA)⟧ *(BB)* section 264(f)(5)(A)(iv) (relating to reporting with respect to certain life insurance and annuity contracts), or

⟦(BB)⟧ *(CC)* section 6050T (relating to returns relating to credit for health insurance costs of eligible individuals).

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CHAPTER 76—JUDICIAL PROCEEDINGS

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Subchapter A—Civil Actions by the United States

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⟦SEC. 7408. ACTION TO ENJOIN PROMOTERS OF ABUSIVE TAX SHELTERS, ETC.

⟦(a) AUTHORITY TO SEEK INJUNCTION.—A civil action in the name of the United States to enjoin any person from further engaging in conduct subject to penalty under section 6700 (relating to penalty for promoting abusive tax shelters, etc.) or section 6701 (relating to penalties for aiding and abetting understatement of tax liability) may be commenced at the request of the Secretary. Any action under this section shall be brought in the district court of the United States for the district in which such person resides, has his principal place of business, or has engaged in conduct subject to penalty under section 6700 or section 6701. The court may exercise its jurisdiction over such action (as provided in section 7402(a)) separate and apart from any other action brought by the United States against such person.

⟦(b) ADJUDICATION AND DECREE.—In any action under subsection (a), if the court finds—

⟦(1) that the person has engaged in any conduct subject to penalty under section 6700 (relating to penalty for promoting abusive tax shelters, etc.) or section 6701 (relating to penalties for aiding and abetting understatement of tax liability), and

⟦(2) that injunctive relief is appropriate to prevent recurrence of such conduct,the court may enjoin such person from engaging in such conduct or in any other activity subject to penalty under section 6700 or section 6701.⟧

SEC. 7408. ACTIONS TO ENJOIN SPECIFIED CONDUCT RELATED TO TAX SHELTERS AND REPORTABLE TRANSACTIONS.

(a) AUTHORITY TO SEEK INJUNCTION.—A civil action in the name of the United States to enjoin any person from further engaging in specified conduct may be commenced at the request of the Secretary. Any action under this section shall be brought in the district court of the United States for the district in which such person resides, has his principal place of business, or has engaged in specified conduct. The court may exercise its jurisdiction over such action (as provided in section 7402(a)) separate and apart from any other action brought by the United States against such person.

(b) ADJUDICATION AND DECREE.—In any action under subsection (a), if the court finds—

(1) that the person has engaged in any specified conduct, and

(2) that injunctive relief is appropriate to prevent recurrence of such conduct,

the court may enjoin such person from engaging in such conduct or in any other activity subject to penalty under this title.

(c) SPECIFIED CONDUCT.—For purposes of this section, the term "specified conduct" means any action, or failure to take action, subject to penalty under section 6700, 6701, 6707, or 6708.

⟦(c)⟧ *(d)* CITIZENS AND RESIDENTS OUTSIDE THE UNITED STATES.—If any citizen or resident of the United States does not reside in, and does not have his principal place of business in, any United States judicial district, such citizen or resident shall be treated for purposes of this section as residing in the District of Columbia.

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CHAPTER 77—MISCELLANEOUS PROVISIONS

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SEC. 7525. CONFIDENTIALITY PRIVILEGES RELATING TO TAXPAYER COMMUNICATIONS.

(a) * * *

[(b) SECTION NOT TO APPLY TO COMMUNICATIONS REGARDING CORPORATE TAX SHELTERS.—The privilege under subsection (a) shall not apply to any written communication between a federally authorized tax practitioner and a director, shareholder, officer, or employee, agent, or representative of a corporation in connection with the promotion of the direct or indirect participation of such corporation in any tax shelter (as defined in section 6662(d)(2)(C)(iii)).]

(b) SECTION NOT TO APPLY TO COMMUNICATIONS REGARDING TAX SHELTERS.—The privilege under subsection (a) shall not apply to any written communication which is—

(1) between a federally authorized tax practitioner and—

(A) any person,

(B) any director, officer, employee, agent, or representative of the person, or

(C) any other person holding a capital or profits interest in the person, and

(2) in connection with the promotion of the direct or indirect participation of the person in any tax shelter (as defined in section 6662(d)(2)(C)(ii)).

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SEC. 7528. INTERNAL REVENUE SERVICE USER FEES.

(a) * * *

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(c) TERMINATION.—No fee shall be imposed under this section with respect to requests made after [December 31, 2004] *September 30, 2013*.

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CHAPTER 79—DEFINITIONS

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SEC. 7701. DEFINITIONS.

(a) WHEN USED IN THIS TITLE, WHERE NOT OTHERWISE DISTINCTLY EXPRESSED OR MANIFESTLY INCOMPATIBLE WITH THE INTENT THEREOF.—

(1) * * *

* * * * * * *

(19) DOMESTIC BUILDING AND LOAN ASSOCIATION.—The term "domestic building and loan association" means a domestic building and loan association, a domestic savings and loan association, and a Federal savings and loan association—

(A) * * *

* * * * * * *

(C) at least 60 percent of the amount of the total assets of which (at the close of the taxable year) consists of—

(i) * * *

* * * * * * *

(ix) loans made for the payment of expenses of college or university education or vocational training, in accordance with such regulations as may be prescribed by the Secretary, *and*

(x) property used by the association in the conduct of the business described in subparagraph (B)【, and】.

【(xi) any regular or residual interest in a REMIC, and any regular interest in a FASIT, but only in the proportion which the assets of such REMIC or FASIT consist of property described in any of the preceding clauses of this subparagraph; except that if 95 percent or more of the assets of such REMIC or FASIT are assets described in clauses (i) through (x), the entire interest in the REMIC or FASIT shall qualify.】

* * * * * * *

(n) SPECIAL RULES FOR DETERMINING WHEN AN INDIVIDUAL IS NO LONGER A UNITED STATES CITIZEN OR LONG-TERM RESIDENT.—An individual who would (but for this subsection) cease to be treated as a citizen or resident of the United States shall continue to be treated as a citizen or resident of the United States, as the case may be, until such individual—

(1) gives notice of an expatriating act or termination of residency (with the requisite intent to relinquish citizenship or terminate residency) to the Secretary of State or the Secretary of Homeland Security, and

(2) provides a statement in accordance with section 6039G.

【(n)】 *(o)* CROSS REFERENCES.—

(1) * * *

* * * * * * *

SEC. 7704. CERTAIN PUBLICLY TRADED PARTNERSHIPS TREATED AS CORPORATIONS.

(a) * * *

* * * * * * *

(d) QUALIFYING INCOME.—For purposes of this section—

(1) * * *

* * * * * * *

(4) CERTAIN INCOME QUALIFYING UNDER REGULATED INVESTMENT COMPANY OR REAL ESTATE TRUST PROVISIONS.—The term "qualifying income" also includes any income which would qualify under section 【851(b)(2)】 *851(b)(2)(A)* or 856(c)(2).

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CHAPTER 80—GENERAL RULES

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Subchapter C—Provisions Affecting More Than One Subtitle

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SEC. 7874. RULES RELATING TO EXPATRIATED ENTITIES AND THEIR FOREIGN PARENTS.

(a) TAX ON INVERSION GAIN OF EXPATRIATED ENTITIES.—

(1) IN GENERAL.—The taxable income of an expatriated entity for any taxable year which includes any portion of the applicable period shall in no event be less than the inversion gain of the entity for the taxable year.

(2) EXPATRIATED ENTITY.—For purposes of this subsection—

(A) IN GENERAL.—The term "expatriated entity" means—

(i) the domestic corporation or partnership referred to in subparagraph (B)(i) with respect to which a foreign corporation is a surrogate foreign corporation, and

(ii) any United States person who is related (within the meaning of section 267(b) or 707(b)(1)) to a domestic corporation or partnership described in clause (i).

(B) SURROGATE FOREIGN CORPORATION.—A foreign corporation shall be treated as a surrogate foreign corporation if, pursuant to a plan (or a series of related transactions)—

(i) the entity completes after March 4, 2003, the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation or substantially all of the properties constituting a trade or business of a domestic partnership,

(ii) after the acquisition at least 60 percent of the stock (by vote or value) of the entity is held—

(I) in the case of an acquisition with respect to a domestic corporation, by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation, or

(II) in the case of an acquisition with respect to a domestic partnership, by former partners of the domestic partnership by reason of holding a capital or profits interest in the domestic partnership, and

(iii) after the acquisition the expanded affiliated group which includes the entity does not have substantial business activities in the foreign country in which, or under the law of which, the entity is created or organized, when compared to the total business activities of such expanded affiliated group.

An entity otherwise described in clause (i) with respect to any domestic corporation or partnership trade or business shall be treated as not so described if, on or before March 4, 2003, such entity acquired directly or indirectly more than half of the properties held directly or indirectly by such corporation or more than half of the properties constituting such partnership trade or business, as the case may be.

(b) DEFINITIONS AND SPECIAL RULES.—

(1) EXPANDED AFFILIATED GROUP.—The term "expanded affiliated group" means an affiliated group as defined in section 1504(a) but without regard to section 1504(b)(3), except that sec-

tion 1504(a) shall be applied by substituting "more than 50 percent" for "at least 80 percent" each place it appears.

(2) CERTAIN STOCK DISREGARDED.—There shall not be taken into account in determining ownership under subsection (a)(2)(B)(ii)—

(A) stock held by members of the expanded affiliated group which includes the foreign corporation, or

(B) stock of such foreign corporation which is sold in a public offering related to the acquisition described in subsection (a)(2)(B)(i).

(3) PLAN DEEMED IN CERTAIN CASES.—If a foreign corporation acquires directly or indirectly substantially all of the properties of a domestic corporation or partnership during the 4-year period beginning on the date which is 2 years before the ownership requirements of subsection (a)(2)(B)(ii) are met, such actions shall be treated as pursuant to a plan.

(4) CERTAIN TRANSFERS DISREGARDED.—The transfer of properties or liabilities (including by contribution or distribution) shall be disregarded if such transfers are part of a plan a principal purpose of which is to avoid the purposes of this section.

(5) SPECIAL RULE FOR RELATED PARTNERSHIPS.—For purposes of applying subsection (a)(2)(B)(ii) to the acquisition of a trade or business of a domestic partnership, except as provided in regulations, all partnerships which are under common control (within the meaning of section 482) shall be treated as 1 partnership.

(6) REGULATIONS.—The Secretary shall prescribe such regulations as may be appropriate to determine whether a corporation is a surrogate foreign corporation, including regulations—

(A) to treat warrants, options, contracts to acquire stock, convertible debt interests, and other similar interests as stock, and

(B) to treat stock as not stock.

(c) OTHER DEFINITIONS.—For purposes of this section—

(1) APPLICABLE PERIOD.—The term "applicable period" means the period—

(A) beginning on the first date properties are acquired as part of the acquisition described in subsection (a)(2)(B)(i), and

(B) ending on the date which is 10 years after the last date properties are acquired as part of such acquisition.

(2) INVERSION GAIN.—The term "inversion gain" means the income or gain recognized by reason of the transfer during the applicable period of stock or other properties by an expatriated entity, and any income received or accrued during the applicable period by reason of a license of any property by an expatriated entity —

(A) as part of the acquisition described in subsection (a)(2)(B)(i), or

(B) after such acquisition if the transfer or license is to a foreign related person.

Subparagraph (B) shall not apply to property described in section 1221(a)(1) in the hands of the expatriated entity.

(3) FOREIGN RELATED PERSON.—The term "foreign related person" means, with respect to any expatriated entity, a foreign person which—

(A) is related (within the meaning of section 267(b) or 707(b)(1)) to such entity, or

(B) is under the same common control (within the meaning of section 482) as such entity.

(d) SPECIAL RULES.—

(1) CREDITS NOT ALLOWED AGAINST TAX ON INVERSION GAIN.—Credits (other than the credit allowed by section 901) shall be allowed against the tax imposed by this chapter on an expatriated entity for any taxable year described in subsection (a) only to the extent such tax exceeds the product of—

(A) the amount of the inversion gain for the taxable year, and

(B) the highest rate of tax specified in section 11(b)(1).

For purposes of determining the credit allowed by section 901, inversion gain shall be treated as from sources within the United States.

(2) SPECIAL RULES FOR PARTNERSHIPS.—In the case of an expatriated entity which is a partnership—

(A) subsection (a)(1) shall apply at the partner rather than the partnership level,

(B) the inversion gain of any partner for any taxable year shall be equal to the sum of—

(i) the partner's distributive share of inversion gain of the partnership for such taxable year, plus

(ii) gain recognized for the taxable year by the partner by reason of the transfer during the applicable period of any partnership interest of the partner in such partnership to the surrogate foreign corporation, and

(C) the highest rate of tax specified in the rate schedule applicable to the partner under this chapter shall be substituted for the rate of tax referred to in paragraph (1).

(3) COORDINATION WITH SECTION 172 AND MINIMUM TAX.—Rules similar to the rules of paragraphs (3) and (4) of section 860E(a) shall apply for purposes of subsection (a).

(4) STATUTE OF LIMITATIONS.—

(A) IN GENERAL.—The statutory period for the assessment of any deficiency attributable to the inversion gain of any taxpayer for any pre-inversion year shall not expire before the expiration of 3 years from the date the Secretary is notified by the taxpayer (in such manner as the Secretary may prescribe) of the acquisition described in subsection (a)(2)(B)(i) to which such gain relates and such deficiency may be assessed before the expiration of such 3-year period notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment.

(B) PRE-INVERSION YEAR.—For purposes of subparagraph (A), the term "pre-inversion year" means any taxable year if—

(i) any portion of the applicable period is included in such taxable year, and

(ii) such year ends before the taxable year in which the acquisition described in subsection (a)(2)(B)(i) is completed.

(e) SPECIAL RULE FOR TREATIES.—Nothing in section 894 or 7852(d) or in any other provision of law shall be construed as permitting an exemption, by reason of any treaty obligation of the United States heretofore or hereafter entered into, from the provisions of this section.

(f) REGULATIONS.—The Secretary shall provide such regulations as are necessary to carry out this section, including regulations providing for such adjustments to the application of this section as are necessary to prevent the avoidance of the purposes of this section, including the avoidance of such purposes through—

(1) the use of related persons, pass-through or other noncorporate entities, or other intermediaries, or

(2) transactions designed to have persons cease to be (or not become) members of expanded affiliated groups or related persons.

* * * * * * *

SECTION 209 OF THE SOCIAL SECURITY ACT

DEFINITION OF WAGES

SEC. 209. (a) For the purposes of this title, the term "wages" means remuneration paid prior to 1951 which was wages for the purposes of this title under the law applicable to the payment of such remuneration, and remuneration paid after 1950 for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash; except that, in the case of remuneration paid after 1950, such term shall not include—

(1)(A) * * *

* * * * * * *

(17) Any benefit provided to or on behalf of an employee if at the time such benefit is provided it is reasonable to believe that the employee will be able to exclude such benefit from income under section 74(c), 117, or 132 of the Internal Revenue Code of 1986; **[**or**]**

(18) Remuneration consisting of income excluded from taxation under section 7873 of the Internal Revenue Code of 1986 (relating to income derived by Indians from exercise of fishing rights)**[**.**]***; or*

(19) Remuneration on account of—

(A) a transfer of a share of stock to any individual pursuant to an exercise of an incentive stock option (as defined in section 422(b) of the Internal Revenue Code of 1986) or under an employee stock purchase plan (as defined in section 423(b) of such Code), or

(B) any disposition by the individual of such stock.

* * * * * * *

TITLE 31, UNITED STATES CODE

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CHAPTER 3—DEPARTMENT OF THE TREASURY

* * * * * * *

SUBCHAPTER II—ADMINISTRATIVE

* * * * * * *

§ 330. Practice before the Department

(a) * * *

* * * * * * *

(b) After notice and opportunity for a proceeding, the Secretary may suspend or disbar from practice before the Department*, or censure,* a representative who—

(1) * * *

* * * * * * *

The Secretary may impose a monetary penalty on any representative described in the preceding sentence. If the representative was acting on behalf of an employer or any firm or other entity in connection with the conduct giving rise to such penalty, the Secretary may impose a monetary penalty on such employer, firm, or entity if it knew, or reasonably should have known, of such conduct. Such penalty shall not exceed the gross income derived (or to be derived) from the conduct giving rise to the penalty. Any such penalty imposed on an individual may be in addition to, or in lieu of, any suspension, disbarment, or censure of such individual.

* * * * * * *

(d) Nothing in this section or in any other provision of law shall be construed to limit the authority of the Secretary of the Treasury to impose standards applicable to the rendering of written advice with respect to any entity, transaction plan or arrangement, or other plan or arrangement, which is of a type which the Secretary determines as having a potential for tax avoidance or evasion.

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CHAPTER 53—MONETARY TRANSACTIONS

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SUBCHAPTER II—RECORDS AND REPORTS ON MONETARY INSTRUMENTS TRANSACTIONS

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§ 5321. Civil penalties

(a)(1) * * *

* * * * * * *

⟦(5) FOREIGN FINANCIAL AGENCY TRANSACTION VIOLATION.—

⟦(A) PENALTY AUTHORIZED.—The Secretary of the Treasury may impose a civil money penalty on any person who willfully violates or any person willfully causing any violation of any violation of any provision of section 5314.

[(B) MAXIMUM AMOUNT LIMITATION.—The amount of any civil money penalty imposed under subparagraph (A) shall not exceed—

[(i) in the case of violation of such section involving a transaction, the greater of—

[(I) the amount (not to exceed $100,000) of the transaction; or

[(II) $25,000; and

[(ii) in the case of violation of such section involving a failure to report the existence of an account or any identifying information required to be provided with respect to such account, the greater of—

[(I) an amount (not to exceed $100,000) equal to the balance in the account at the time of the violation; or

[(II) $25,000.]

(5) FOREIGN FINANCIAL AGENCY TRANSACTION VIOLATION.—

(A) PENALTY AUTHORIZED.—The Secretary of the Treasury may impose a civil money penalty on any person who violates, or causes any violation of, any provision of section 5314.

(B) AMOUNT OF PENALTY.—

(i) IN GENERAL.—Except as provided in subparagraph (C), the amount of any civil penalty imposed under subparagraph (A) shall not exceed $5,000.

(ii) REASONABLE CAUSE EXCEPTION.—No penalty shall be imposed under subparagraph (A) with respect to any violation if—

(I) such violation was due to reasonable cause, and

(II) the amount of the transaction or the balance in the account at the time of the transaction was properly reported.

(C) WILLFUL VIOLATIONS.—In the case of any person willfully violating, or willfully causing any violation of, any provision of section 5314—

(i) the maximum penalty under subparagraph (B)(i) shall be increased to the greater of—

(I) $25,000, or

(II) the amount (not exceeding $100,000) determined under subparagraph (D), and

(ii) subparagraph (B)(ii) shall not apply.

(D) AMOUNT.—The amount determined under this subparagraph is—

(i) in the case of a violation involving a transaction, the amount of the transaction, or

(ii) in the case of a violation involving a failure to report the existence of an account or any identifying information required to be provided with respect to an account, the balance in the account at the time of the violation.

*   *   *   *   *   *   *

SECTION 13031 OF THE CONSOLIDATED OMNIBUS BUDGET RECONCILIATION ACT OF 1985

SEC. 13031. FEES FOR CERTAIN CUSTOMS SERVICES.

(a) SCHEDULE OF FEES.—In addition to any other fee authorized by law, the Secretary of the Treasury shall charge and collect the following fees for the provision of customs services in connection with the following:

(1) * * *

* * * * * * *

(5)(A) * * *

(B) For the arrival of each passenger aboard a commercial vessel from a place referred to in subsection (b)(1)(A)(i) of this section, [$1.75] *$1.75.*

(b) LIMITATIONS ON FEES.—(1)(A) Except as provided in subsection (a)(5)(B) of this section, no fee may be charged under subsection (a) of this section for customs services provided in connection with—

(i) * * *

* * * * * * *

(iii) the arrival of a ferry, except for a ferry whose operations begin on or after August 1, 1999, and that operates south of 27 degrees latitude and east of 89 degrees longitude; or

* * * * * * *

(7) No fee may be charged under [paragraphs] *paragraph* (2), (3), or (4) of subsection (a) for the arrival of any—

(A) * * *

* * * * * * *

(9)(A) * * *

* * * * * * *

(B)(i) Beginning in fiscal year 2004, the Secretary of the Treasury may adjust (not more than once per fiscal year) the amount described in subparagraph (A)(ii) to an amount that is not less than $.35 and not more than $1.00 per individual airway bill or bill of lading. The Secretary shall provide notice in the Federal Register of a proposed adjustment under the preceding sentence and the reasons therefor and shall allow for public comment on the proposed adjustment.

(ii) Notwithstanding section 451 of the Tariff Act of 1930, the payment required by subparagraph (A)(ii) shall be the only payment required for reimbursement of the Customs Service in connection with the processing of an individual airway bill or bill of lading in accordance with such subparagraph and for providing services at express consignment carrier facilities or centralized hub facilities, except that the Customs Service may require such facilities to cover expenses of the Customs Service for adequate office space, equipment, furnishings, supplies, and security.

(iii)(I) The payment required by subparagraph (A)(ii) and clause (ii) of this subparagraph shall be paid on a quarterly basis by the carrier using the facility to the Customs Service in accordance with regulations prescribed by the Secretary of the Treasury.

(II) 50 percent of the amount of payments received under subparagraph (A)(ii) and clause (ii) of this subparagraph shall, in accordance with section 524 of the Tariff Act of 1930, be deposited in the Customs User Fee Account and shall be used to directly reimburse each appropriation for the amount paid out of that appropriation for the costs incurred in providing services to express consignment carrier facilities or centralized hub facilities. Amounts deposited in accordance with the preceding sentence shall be available until expended for the provision of customs services to express consignment carrier facilities or centralized hub facilities.

(III) Notwithstanding section 524 of the Tariff Act of 1930, the remaining 50 percent of the amount of payments received under subparagraph (A)(ii) and clause (ii) of this subparagraph shall be paid to the Secretary of the Treasury, which is in lieu of the payment of fees under subsection (a)(10) of this section.

* * * * * * *

(e) PROVISION OF CUSTOMS SERVICES.—

(1) * * *

(2)(A) * * *

(B) Subparagraph (C) of paragraph (6) shall not apply with respect to any foreign trade zone or subzone that is located at, or in the vicinity of, an airport to which section 236 of the Trade and Tariff Act of 1984 applies.

* * * * * * *

(f) DISPOSITION OF FEES.—(1) There is established in the general fund of the Treasury a separate account which shall be known as the "Customs User Fee Account". Notwithstanding section 524 of the Tariff Act of 1930 (19 U.S.C. 1524), there shall be deposited as offsetting receipts into the Customs User Fee Account all fees collected under subsection (a) except—

(A) * * *

(B) amounts deposited into the Customs Commercial and Homeland Security Automation Account under paragraph (5).

(2) Except as otherwise provided in this subsection, all funds in the Customs User Fee Account shall be available, to the extent provided for in appropriations Acts, to pay the costs (other than costs for which direct reimbursement under paragraph (3) is required) incurred by the United States Customs Service in conducting [commercial operations, including, but not limited to, all costs associated with commercial passenger, vessel, vehicle, aircraft, and cargo processing.] *customs revenue functions as defined in section 415 of the Homeland Security Act of 2002 (other than functions performed by the Office of International Affairs referred to in section 415(8) of that Act), and for automation (including the Automation Commercial Environment computer system), and for no other purpose. To the extent that funds in the Customs User Fee Account are insufficient to pay the costs of such customs revenue functions, customs duties in an amount equal to the amount of such insufficiency shall be available, to the extent provided for in appropriations Acts, to pay the costs of such customs revenue functions in the amount of such insufficiency, and shall be available for no other purpose. The provisions of the first and second sentences of this paragraph specifying the purposes for which amounts in the Customs User Fee Account may be made available shall not be superseded except by a provision of law which specifically modifies or supersedes such provisions.* So long as there is a surplus of funds in the Customs User

Fee Account, the Secretary of the Treasury may not reduce personnel staffing levels for providing commercial clearance and preclearance services.

(3)(A) * * *

* * * * * * *

(E) Nothing in this paragraph shall be construed to preclude the use of appropriated funds, from sources other than the fees collected under subsection (a), to pay the costs set forth in clauses (i), (ii), and (iii) of subparagraph (A).

* * * * * * *

(j) EFFECTIVE DATES.—(1) * * *

* * * * * * *

[(3) Fees may not be charged under subsection (a) after March 1, 2005.]

(3)(A) Fees may not be charged under paragraphs (9) and (10) of subsection (a) after September 30, 2013.

(B)(i) Subject to clause (ii), Fees may not be charged under paragraphs (1) through (8) of subsection (a) after September 30, 2013.

(ii) In fiscal year 2006 and in each succeeding fiscal year for which fees under paragraphs (1) through (8) of subsection (a) are authorized—

(I) the Secretary of the Treasury shall charge fees under each such paragraph in amounts that are reasonably related to the costs of providing customs services in connection with the activity or item for which the fee is charged under such paragraph, except that in no case may the fee charged under any such paragraph exceed by more than 10 percent the amount otherwise prescribed by such paragraph;

(II) the amount of fees collected under such paragraphs may not exceed, in the aggregate, the amounts paid in that fiscal year for the costs described in subsection (f)(3)(A) incurred in providing customs services in connection with the activity or item for which the fees are charged under such paragraphs;

(III) a fee may not be collected under any such paragraph except to the extent such fee will be expended to pay the costs described in subsection (f)(3)(A) incurred in providing customs services in connection with the activity or item for which the fee is charged under such paragraph; and

(IV) any fee collected under any such paragraph shall be available for expenditure only to pay the costs described in subsection (f)(3)(A) incurred in providing customs services in connection with the activity or item for which the fee is charged under such paragraph.

* * * * * * *

VII. DISSENTING VIEWS

There are many issues that deeply divide the two parties in Congress. Issues like privatization of Medicare and Social Security, unemployment benefits, health insurance for the uninsured, funding of education programs, and fiscally irresponsible tax cuts define the differences between the two parties. We welcome an energetic, partisan dispute on those issues.

However, we do not believe that the issue of how to respond to the European challenge to our export-related tax benefits, called Foreign Sales Corporations/Extra-Territorial Income (FSC/ETI), should be the subject of a partisan dispute. There should not be a Democratic or Republican response to a challenge from our foreign competitors. There should be an American position to respond to the European position.

This is not the first time that our export-related tax benefits have been subject to a challenge by our foreign competitors. In the past, such challenges were met with a bipartisan, unified American response. We did not show our divisions, nor did Americans share legal briefs, with our opponents.

Unfortunately, there was a unilateral choice made last year to use this issue to enact an unrelated, partisan agenda. That agenda involved a long list of liberalizations to the tax rules that apply to the overseas operations of our multinationals. Essentially, the choice last year was to increase taxes on domestic manufacturers (through repeal of FSC/ETI) and use the money to subsidize offshore operations of U.S. multinationals.

As a country, we have paid a heavy price for that unilateral decision. It has delayed our response to the World Trade Organization (WTO) ruling by over a year, creating the potential for imposition of trade sanctions on our exports. During that one-year period, there has been an unrelenting attack on the substance of many of the provisions that have now been included in the Committee bill. Those attacks, in effect, have shared legal briefs and arguments that our European competitors now can use to challenge the U.S. response.

It need not have been handled that way. Congressmen Crane, Rangel, Manzullo and Levin introduced legislation (H.R. 1769) which demonstrates that a bipartisan, unified American response to the WTO challenge is possible. That legislation has approximately 150 cosponsors, equally divided between parties.

We had been hopeful that we could at least support the domestic manufacturing part of the Chairman's bill. Unfortunately, the Chairman decided not to include the substance of H.R. 1769. Instead, he included a deeply flawed provision that provides special interest benefits to large architectural and engineering companies like Bechtel and Halliburton.

Even if the Committee bill had included H.R. 1769, we could not support it because it includes many other provisions unrelated to the FSC/ETI issues. It is another fiscally irresponsible tax cut that threatens U.S. jobs. It is a bill that is dead on arrival in the Senate, creating the possibility of an impasse that could result in trade sanctions. It continues to use this trade dispute to enact an unrelated agenda, an agenda that threatens U.S. jobs. Following is an elaboration of our reasons for opposition.

1. BUDGET IMPACT

The Committee bill is another in a series of reckless tax bills that have resulted in unprecedented deficits. The Committee bill is estimated to add at least another $60 billion to projected Federal deficits over the next 10 years. However, the real cost of the bill will be far larger. The Committee bill resorts to long phase-ins, delayed effective dates, and temporary provisions to reduce its official score.

The tricks that have been used to hide the true cost of the bill are evident when one reviews the Joint Committee on Taxation revenue table that estimates a revenue loss of almost $12 billion in fiscal year 2013, a loss that is growing year-by-year. More than half of the revenue losses would occur in the last three years of the 10 year budget window. In addition, outyear costs will be even higher because some of the offsets in the bill are slated to expire at the end of 2013, while the tax cuts are permanent.

All this gimmickry is occurring at a time when the Congressional Budget Office (CBO) projects unprecedented deficits. The most recent CBO budget projections make it clear that the deficits are not temporary. Instead, they are structural and will not fade away even if we experience good economic growth. The official projections of $1.4 trillion in deficits over the next 10 years ignore the fact that the deficits would be $3.8 trillion if the Administration had not abandoned its commitment to wall-off the Social Security surpluses. Most private estimators suggest that the deficits will be in the range of $4–5 trillion over the next 10 years. Those projections would be in the range of $6.4–7.4 trillion if Social Security surpluses were walled off.

As a result of the last two years of Republican tax policy, our tax laws are gimmick-ridden. To artificially reduce the official cost of their bills, Republicans have resorted to a vast assortment of gimmicks, such as long phase-ins, temporary provisions, delayed effective dates, and sunsets. As a result, we have a tax law that is extraordinarily unstable. It is difficult to predict exactly what our law will be in the future. Since businesses and other taxpayers cannot make plans on the basis of an unstable tax law, it is doubtful that many of the tax incentives enacted by the Congress will have any real positive effect. The Committee bill makes a bad situation worse.

2. SUBSIDIES FOR OFFSHORE OPERATIONS

The Committee bill provides approximately $40 billion in net tax cuts for the overseas operations of U.S. multinationals. That amount represents approximately two-thirds of the total cost of the bill.

These additional tax benefits for the offshore operations of U.S. multinationals are being considered at a time when the manufacturing sector of our economy is in a crisis of historic proportions. Over the last year, our economy has lost nearly 700,000 manufacturing jobs. Of the 2.7 million jobs the economy has lost during this Bush presidency, 2.5 million of those were in manufacturing. For 38 straight months, the manufacturing sector of our economy has lost jobs, the longest such stretch since the Great Depression.

The Committee bill responds to the loss of domestic manufacturing jobs by expanding tax benefits for the offshore operations of U.S. multinationals. The Committee bill ignores the fact that FSC/ETI, and their predecessor, Domestic International Sales Corporations (DISC), were enacted because our foreign tax rules already were so generous that they operated to disadvantage U.S. producers. The following excerpt from the 1971 House Committee report makes this clear.

> This [i.e., the DISC provision] is important not only because of its stimulative effect but also remove a present disadvantage of U.S. companies engaged in export activities through domestic corporations. Presently, they are treated less favorably than those which manufacture abroad through the use of foreign subsidiary corporations.

Our international tax rules have long been one of our most contentious tax issues. Optimally, our foreign tax rules should be a balance between a desire to ensure that U.S. multinationals are competitive overseas and the desire not to create incentives for U.S. companies to move operations out of the United States. Unfortunately, our rules are sadly out of balance, and they now contribute to the growing flight of manufacturing jobs from the United States.

In 2001, the American Enterprise Institute published an article by two economists (one of whom is a Treasury economist) that analyzed the impact of adopting a territorial tax system in the United States, similar to the system used by some foreign countries. Under a territorial system, the foreign active business earnings of our multinationals would be totally exempt from federal income tax. Surprisingly, the article concluded that providing such a total exemption would increase, not decrease, the U.S. taxes paid by our multinationals. The classic definition of a negative income tax is a tax system which provides greater benefits than a total exemption from tax would provide. Using that definition, there is an overall negative tax on the overseas business operations of U.S. companies.

The surprising conclusion of the 2001 article was validated in 2002 when a group of 32 large U.S. multinationals published a study on whether the U.S. should adopt a territorial system. Those multinationals concluded that "on balance" providing them with a total exemption from tax on their foreign business operations would be unwise. The only logical assumption is that those companies, like the two Treasury economists, concluded that an exemption system would provide fewer benefits than the current tax system provides.

Again, it is worth emphasizing that our export-related tax benefits (currently the FSC/ETI provisions) were enacted by the Congress because our tax laws disadvantage U.S. producers because the rules are much more generous overseas. Currently, there is an overall negative tax on the active business operations of our multinationals. Increasing the size of that negative tax, as proposed by the Committee bill, will simply accelerate the movement of manufacturing jobs out of the United States.

3. SMALL NET BENEFITS FOR U.S. MANUFACTURERS

The main benefit in the Committee bill for U.S. manufacturers is a $61 billion rate adjustment if one assumes that all of that rate reduction really goes to profits from manufacturing actually taking place in the United States. However, the bill also repeals FSC/ETI, a benefit that is almost exclusively enjoyed by U.S. manufacturers. Therefore, the net benefit for U.S. manufacturers in the bill is $18 billion, less than one-third of its $60 billion cost.

The share of the cost enjoyed by U.S. manufacturers shrinks over time. In 2013, U.S. manufacturers receive a net tax cut of $2.5 billion, slightly more than 20% of the total net cut provided by the bill.

4. BILL UNLIKELY TO PASS SENATE

The Committee bill does not even accomplish the goal of bringing our tax laws into compliance with the WTO ruling. The Senate has made it quite clear that any legislation on this issue will be revenue neutral. Therefore, it is unlikely that the House bill will receive serious consideration in the Senate. Some have suggested that the House is not bound by the Senate views and should exercise its prerogative. Individuals making that argument have also argued strenuously that we must respect the views of the European Union. We would suggest that we should treat the views of the Senate with the same respect that we accord the views of foreign countries. The bill will have to be revenue neutral to pass the United States Senate and, therefore, it is important for the House to develop revenue neutral legislation.

Our opposition to the Committee bill is made easy by the fact that there is a simple, revenue-neutral alternative that could resolve the trade dispute and protect U.S. jobs. Rep. Rangel offered that alternative in Committee. It is based on the Senate Finance Committee bill and would facilitate Senate action. His alternative contains the following elements.

(1) The alternative would contain a rate reduction for all U.S. manufacturers, including subchapter S corporations, partnerships and proprietorships. The rate adjustment would be 3.5 points.

(2) The alternative would be revenue neutral, using the money from repeal of FSC/ETI, customs user fees extension, and Enron-related tax shelter provisions. This is essentially the approach followed by the Senate Finance Committee. The alternative is structured so that it does not have large, growing out-year costs.

(3) The alternative would provide farms, and other small business manufacturers with a permanent tax benefit worth approximately $15 billion over 10 years. The only benefit for non-corporate taxpayers in the Committee bill is a temporary extension of an existing provision. The alternative would also extend that provision.

(4) The alternative includes provisions that reward companies for keeping jobs in the United States. It contains none of the provisions from the Committee bill that reward companies for moving jobs offshore.

The Republicans who opposed the Rangel substitute in the Committee voted for a bill that would provide fewer benefits for most taxable corporations operating in the United States and voted for a bill that would provide fewer benefits for all subchapter S corporations, farmers, farm cooperatives, and other unincorporated U.S. businesses. They voted for a bill that would create a partisan impasse that could threaten trade sanctions. They may wish to reconsider that decision on the Floor.

FACTUAL COMPARISON OF FSC/ETI RANGEL SUBSTITUTE TO THOMAS BILL

1. Effect on deficit	Substitute is revenue neutral with no ballooning out-year revenue cost. Substitute is consistent with Bush Administration position that FSC/ETI legislation should be revenue neutral	Thomas bill officially is scored as costing about $60 billion. True cost of bill is far higher. Bill contains long phase ins and temporary tax provisions to hide true costs. Even with those gimmicks, Thomas bill has large ballooning out-year revenue costs, approximately $12 billion per year. Thomas bill is inconsistent with Bush Administration position that FSC/ETI legislation should be revenue neutral
2. Subsidies for companies that move jobs offshore.	Substitute includes no provisions that provide additional tax benefits for companies with offshore business operations. Corporate rate reduction in substitute is structured to reward companies that keep their jobs in the United States	Thomas bill contains an additional $40 billion of tax benefits for the offshore business operations of U.S. multinationals. Bill substantially liberalizes current law rules limiting cross-crediting of foreign taxes, in effect providing tax credits for moving business operations offshore. Thomas bill corporate rate reduction is not designed to reward companies keeping jobs in U.S.
3. Rate reductions for manufacturing activities of taxable corporations.	Substitute provides a ten percent across-the-board corporate rate reduction for income from U.S. manufacturing activities. Large corporations receive 3.5 point reduction, from 35% to 31.5%. Smaller corporations receive 3.4 point reduction from 34% to 30.6%. Benefits for large and small corporations are phased in at the same pace. Rate reductions are adjusted to reward companies keeping jobs in U.S. None of the benefits of the rate reductions in Rangel substitute are taken back through imposition of new corporate surtaxes	Thomas bill provides 3 point rate reduction for large corporations (from 35% to 32%) and a 2 point reduction for small corporations from 34% to 32%. Benefits for large corporations phasein much more rapidly than for small corporations. Rate reductions for large corporations fully take effect in 2007. Rate reductions for small corporations do not fully take effect until 2012. Benefits for small corporations are taken back through imposition of new corporate surtax. Rate reductions are not structured to reward companies for keeping jobs in U.S.
4. Benefits for subchapter S corporations and other noncorporate taxpayers.	A. Substitute includes 2–year extension of current law small business expensing benefits	A. Thomas bill includes 2–year extension of current law small business expensing benefits.
	B. Substitute provides 3.5 point rate reduction for shareholders of subchapter S corporations and other non-corporate taxpayers engaged in farming business or in other businesses involving the production of tangible goods	B. Thomas bill includes no rate adjustment for subchapter S corporations and other noncorporate taxpayers. The only rate reductions in the Thomas bill are for taxable corporations, with biggest benefit for large corporations.
5. Benefits for farmers	Under substitute, farmers are eligible for a 3.5 point rate reduction, and farmer cooperatives receive benefits consistent with their treatment under ETI	Thomas bill provides no rate reduction for farmers and no benefits for farm coops other than a small $14 million provision.
6. Repeal of FSC/ETI	Substitute repeals FSC/ETI with binding contract transition rules and 3–year general transition relief. General transition relief structured to be WTO compatible	Thomas bill provides binding contract relief and three-year general transition. The general transition is not WTO compatible.
7. Special interest provisions.	A. Substitute provides benefits only for manufacturers. Service companies are not eligible	A. Thomas bill provides rate reduction for companies like Halliburton and Bechtel that provide engineering and architectural services. No other service companies are eligible.
	B. Substitute contains no miscellaneous tax benefits	B. Thomas bill contains numerous miscellaneous tax benefits.

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