[JOINT COMMITTEE PRINT]

GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 106TH CONGRESS

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

APRIL 19, 2001

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U.S. GOVERNMENT PRINTING OFFICE

71–652 WASHINGTON : 2001 JCS–2–01

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation in consultation with the staffs of the House Committee on Ways and Means and Senate Committee on Finance, provides an explanation of tax legislation enacted in the 106th Congress. The explanation follows the chronological order of the tax legislation as signed into law.

A committee report on legislation issued by a Congressional committee sets forth the committee's explanation of the bill as it was reported by that committee. In some instances, a committee report does not serve as an explanation of the final provisions of the legislation as enacted. This is because the version of the bill enacted after action by the Conference Committee may differ significantly from the versions of the bill reported by the House and Senate Committees and passed by the House and Senate. The material contained in this pamphlet is prepared so that Members of Congress, tax practitioners, and other interested parties can have an explanation in one volume of the final tax legislation enacted in 106th Congress.

In some instances, provisions included in legislation enacted in the 106th Congress were not reported out of committee before enactment. As a result, the legislative history of such provisions does not include the reasons for change normally included in a committee report. In the case of such provisions, no reasons for change are included with the explanation of the provision in this pamphlet.

Part One of the pamphlet is a explanation of the provisions of the Availability of Certain Tax Benefits for Services for Part of Operation Allied Force (P.L. 106–21), relating to tax treatment of certain of military personnel and civilian employees in the Federal Republic of Yugoslavia (Bosnia/Montenegro), Albania, the Adriatic Sea, and the northern Ionian Sea above the 39th parallel. Part Two is an explanation of the revenue provisions of the Miscellaneous Trade and Technical Corrections Act of 1999 (P.L. 106–36), relating to treatment of certain property subject to a liability. Part Three is an explanation of the Tax Relief Extension Act of 1999 (Title V of the Ticket to Work and Work Incentives Improvement Act of 1999, P.L. 106–170), relating to extension of expiring provisions and other time-sensitive provisions, with revenue offset provisions. Part Four is an explanation of the revenue provisions of the Trade and Development Act of 2000 (P.L. 106–200), relating to foreign tax credit rules and cover over payments to Puerto Rico and the Virgin Islands. Part Five is an explanation of provisions Amending the Internal Revenue Code to Require 527 Organizations to Disclose their Political Activities (P.L. 106–230), Part Six is an explanation of the

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 106th Congress (JCS–2– 01), April 19, 2001.

revenue provisions of the Miscellaneous Trade and Technical Corrections Act of 2000 (P.L. 106–476), relating to imported cigarette compliance. Part Seven is an explanation of the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 (P.L. 106–519), relating to repeal of rules for foreign sales corporations. Part Eight is an explanation of the revenue provisions of the Community Renewal Tax Relief Act of 2000 (P.L. 106–554, H.R. 5662), relating to community renewal, medical savings accounts, administrative and technical corrections, and tax treatment of securities futures contracts. Part Nine is an explanation of the Installment Tax Correction Act of 2000 (P.L. 106–573), relating to repeal of the prohibition on the use of the installment method of accounting for certain dispositions. The Appendix provides the estimated budget effects of tax legislation enacted in the 106th Congress.

PART ONE: AVAILABILITY OF CERTAIN TAX BENEFITS FOR SERVICES FOR PART OF OPERATION ALLIED FORCE (PUBLIC LAW 106–21) [2]

Present and Prior Law

General time limits for filing tax returns

Individuals generally must file their Federal income tax returns by April 15 of the year following the close of a taxable year (sec. 6072). The Secretary may grant reasonable extensions of time for filing such returns (sec. 6081). Treasury regulations provide an additional automatic two-month extension (until June 15 for calendar-year individuals) for United States citizens and residents in military or naval service on duty on April 15 of the following year (the otherwise applicable due date of the return) outside the United States (Treas. Reg. sec. 1.6081–5(a)(6)). No action is necessary to apply for this extension, but taxpayers must indicate on their returns (when filed) that they are claiming this extension. Unlike most extensions of time to file, this extension applies to both filing returns and paying the tax due.

Treasury regulations also provide, upon application on the proper form, an automatic four-month extension (until August 15 for calendar-year individuals) for any individual timely filing that form and paying the amount of tax estimated to be due (Treas. Reg. sec. 1.6081–4).

In general, individuals must make quarterly estimated tax payments by April 15, June 15, September 15, and January 15 of the following taxable year. Wage withholding is considered to be a payment of estimated taxes.

Suspension of time periods

In general, the period of time for performing various acts under the Internal Revenue Code, such as filing tax returns, paying taxes, or filing a claim for credit or refund of tax, is suspended for any individual serving in the Armed Forces of the United States in an area designated as a "combat zone" during the period of combatant activities (sec. 7508). An individual who becomes a prisoner of war is considered to continue in active service and is therefore also eligible for these suspension of time provisions. The suspension of time also applies to an individual serving in support of such Armed Forces in the combat zone, such as Red Cross personnel, accredited correspondents, and civilian personnel acting under the direction of the Armed Forces in support of those Forces. The designation of a combat zone must be made by the President in an Ex-

[2] H.R. 1376. The bill was ordered reported by the House Committee on Ways and Means on April 13, 1999 (H. Rep. 106–90). The House and the Senate both passed the bill on April 15, 1999. The bill was signed by the President on April 19, 1999.

ecutive Order. The President must also designate the period of combatant activities in the combat zone (the starting date and the termination date of combat).

The suspension of time encompasses the period of service in the combat zone during the period of combatant activities in the zone, as well as (1) any time of continuous qualified hospitalization resulting from injury received in the combat zone[3] or (2) time in missing in action status, plus the next 180 days.

The suspension of time applies to the following acts:

(1) Filing any return of income, estate, or gift tax (except employment and withholding taxes);

(2) Payment of any income, estate, or gift tax (except employment and withholding taxes);

(3) Filing a petition with the Tax Court for redetermination of a deficiency, or for review of a decision rendered by the Tax Court;

(4) Allowance of a credit or refund of any tax;

(5) Filing a claim for credit or refund of any tax;

(6) Bringing suit upon any such claim for credit or refund;

(7) Assessment of any tax;

(8) Giving or making any notice or demand for the payment of any tax, or with respect to any liability to the United States in respect of any tax;

(9) Collection of the amount of any liability in respect of any tax;

(10) Bringing suit by the United States in respect of any liability in respect of any tax; and

(11) Any other act required or permitted under the internal revenue laws specified in regulations prescribed under section 7508 by the Secretary of the Treasury.

Individuals may, if they choose, perform any of these acts during the period of suspension.

Spouses of qualifying individuals are entitled to the same suspension of time, except that the spouse is ineligible for this suspension for any taxable year beginning more than two years after the date of termination of combatant activities in the combat zone.

Exclusion for combat zone compensation

Gross income does not include certain combat zone compensation of members of the Armed Forces (sec. 112). If enlisted personnel serve in a combat zone during any part of any month, military pay for that month is excluded from gross income. In addition, if enlisted personnel are hospitalized as a result of injuries, wounds, or disease incurred in a combat zone, military pay for that month is also excluded from gross income; this exclusion is limited, however, to hospitalization during any part of any month beginning not more than two years after the end of combat in the zone. In the case of

[3] Two special rules apply to continuous hospitalization inside the United States. First, the suspension of time provisions based on continuous hospitalization inside the United States are applicable only to the hospitalized individual; they are not applicable to the spouse of such individual. Second, in no event do the suspension of time provisions based on continuous hospitalization inside the United States extend beyond five years from the date the individual returns to the United States. These two special rules do not apply to continuous hospitalization outside the United States.

commissioned officers, these exclusions from income are limited to the maximum enlisted amount[4] of military pay.

Income tax withholding does not apply to military pay to the extent that an employee (whether enlisted personnel or commissioned officer) is entitled to the exclusion from income for combat pay (sec. 3401(a)(1)).

Exemption from tax upon death in a combat zone

An individual in active service as a member of the Armed Forces who dies while serving in a combat zone (or as a result of wounds, disease, or injury received while serving in a combat zone) is not subject to income tax for the year of death (as well as for any prior taxable year ending on or after the first day the individual served in the combat zone) (sec. 692). Special computational rules apply in the case of joint returns. A reduction in estate taxes is also provided with respect to individuals dying under these circumstances (sec. 2201).

Special rules permit the filing of a joint return where a spouse is in missing status as a result of service in a combat zone (sec. 6013(f)(1)). Special rules for determining surviving spouse status apply where the deceased spouse was in missing status as a result of service in a combat zone (sec. 2(a)(3)).

Exemption from telephone excise tax

The telephone excise tax is not imposed on "any toll telephone service" that originates in a combat zone (sec. 4253(d)).

Operation Desert Storm: Executive Order designating Persian Gulf Area as a combat zone

On January 21, 1991, President Bush signed Executive Order 12744, designating the Persian Gulf Area as a combat zone. This designation was retroactive to January 17, 1991, the date combat commenced in that area, and continues in effect until terminated by another Executive Order. An Executive Order terminating this combat zone designation has not been issued. Thus, individuals serving in the Persian Gulf Area are eligible for the suspension of time provisions and military pay exclusions (among other provisions) described above, beginning on January 17, 1991.

The Executive Order specifies that the Persian Gulf Area is the Persian Gulf, the Red Sea, the Gulf of Oman, part of the Arabian Sea, the Gulf of Aden, and the entire land areas of Iraq, Kuwait, Saudi Arabia, Oman, Bahrain, Qatar, and the United Arab Emirates.

Operation Desert Shield: Legislative extension of time

On January 30, 1991, President Bush signed Public Law 102–2. This Act amended section 7508 by providing that any individual who performs Desert Shield services (and the spouse of such an individual) is entitled to the benefits of the suspension of time provisions of section 7508. Desert Shield services are defined as services

[4] This is defined as the higher rate of basic pay at the highest pay grade applicable for that month to any enlisted member of the Armed Forces of the United States, plus, in the case of an officer entitled to combat pay, the amount of combat pay payable to that officer for that month. (sec. 112(c)(5)).

in the Armed Forces of the United States (or in support of those Armed Forces) if such services are performed in the area designated by the President as the "Persian Gulf Desert Shield area" and such services are performed during the period beginning August 2, 1990, and ending on the date on which any portion of the area was designated by the President as a combat zone pursuant to section 112 (which was January 17, 1991).

Operation Joint Endeavor: Administrative extension of time

On December 12, 1995, the Internal Revenue Service announced[5] that it was administratively extending the time to file tax returns until December 15, 1996, for members of the Armed Forces "departing 'Operation Joint Endeavor'" on or after March 1, 1996. In addition, the IRS stated that the penalties for failure to file tax returns and failure to pay taxes would not be assessed with respect to these individuals. Also, the IRS stated that it would administratively place any balance due accounts into suspense status and suspend examinations while the member is serving in "Operation Joint Endeavor."

Operation Joint Endeavor and Operation Able Sentry: Legislative treatment as if a combat zone

Pursuant to Public Law 104–117,[6] a qualified hazardous duty area is treated in the same manner as if it were a combat zone for purposes of the following provisions of the Code:

(1) the special rule for determining surviving spouse status where the deceased spouse was in missing status as a result of service in a combat zone (sec. 2(a)(3));

(2) the exclusions from income for combat pay (sec. 112);

(3) forgiveness of income taxes of members of the Armed Forces dying in the combat zone or by reason of combat-zone incurred wounds (sec. 692);

(4) the reduction in estate taxes for members of the Armed Forces dying in the combat zone or by reason of combat-zone incurred wounds (sec. 2201);

(5) the exemption from income tax withholding for military pay for any month in which an employee is entitled to the exclusion from income (sec. 3401(a)(1));

(6) the exemption from the telephone excise tax for toll telephone service that originates in a combat zone (sec. 4253(d));

(7) the special rule permitting filing of a joint return where a spouse is in missing status as a result of service in a combat zone (sec. 6013(f)(1)); and

(8) the suspension of time provisions (sec. 7508).

A qualified hazardous duty area means Bosnia and Herzegovina, Croatia, or Macedonia, if, as of the date of enactment, any member of the Armed Forces is entitled to hostile fire/imminent danger pay for services performed in such country. Members of the Armed Forces are in Bosnia and Herzegovina and Croatia as part of "Op-

[5] Letter dated December 12, 1995, from John T. Lyons, Assistant Commissioner (International), Internal Revenue Service, to Lt. Col. David M. Pronchick, Armed Forces Tax Counsel, Department of Defense.

[6] 110 Stat. 827 (March 20, 1996).

eration Joint Endeavor" (the NATO operation).[7] Members of the Armed Forces are in Macedonia as part of "Operation Able Sentry" (the United Nations operation). In addition, persons other than Members of the Armed Forces who are serving in support of these operations of the Armed Forces are eligible for the suspension of time provisions in section 7508 of the Code.[8] This provision was effective on November 21, 1995 (the date the Dayton Accord was initialed).

Suspension of time provisions for other Operation Joint Endeavor personnel

An individual who is performing services as part of Operation Joint Endeavor outside the United States while deployed away from the individual's permanent duty station will qualify for the suspension of time provisions in section 7508 of the Code during the period that hostile fire/imminent danger pay is paid in Bosnia and Herzegovina, Croatia, or Macedonia.

Announcement of intention to issue Executive Order designating Kosovo area of operations as a combat zone

On April 12, 1999, President Clinton announced his intention to issue an Executive Order designating the Federal Republic of Yugoslavia (Serbia/Montenegro), Albania, the Adriatic Sea, and the northern Ionian Sea (including all of their air spaces) as a combat zone for purposes of the Internal Revenue Code.

Reasons for Change

The Congress believed that it was appropriate to apply the special tax rules applicable to combat zones to service in the Federal Republic of Yugoslavia (Serbia/Montenegro), Albania, the Adriatic Sea, and the Northern Ionian Sea in the same manner as if those areas were a combat zone. In addition, the Congress believed that it was appropriate to provide that military personnel performing services outside of those areas but still a part of Operation Allied Force qualify for the suspension of time provisions in section 7508 of the Code during the period that hostile fire/imminent danger pay is paid with respect to those areas, provided that those services are performed both outside the United States and while deployed away from that individual's duty station.

Explanation of Provision

The Act contains two elements. First, the Act treats the Federal Republic of Yugoslavia (Serbia/Montenegro), Albania, the Adriatic Sea, and the northern Ionian Sea above the 39th parallel (including all of their air spaces) as a qualified hazardous duty area. Con-

[7] Operation Joint Endeavor has been replaced by Operation Joint Forge. The IRS has stated that personnel serving under Operation Joint Forge will be treated the same as personnel under Operation Joint Endeavor because Joint Forge is "the substantive continuation" of Joint Endeavor. Letter dated July 17, 1998, from Tommy G. DeWeese, District Director for the International District, Internal Revenue Service, to LTC Thomas K. Emswiler, Armed Forces Tax Council, Department of Defense.

[8] In addition, persons other than Members of the Armed Forces are eligible for some of the other seven provisions listed above, under specified circumstances. For example, civilian employees of the United States are eligible for the forgiveness of income tax provisions of section 692 if they die as a result of injuries sustained overseas in specified terroristic or military actions.

sequently, military personnel serving in those areas are entitled to relief under all eight of the hazardous duty area provisions listed above. Several special rules apply to civilian personnel. Civilian personnel serving in those areas in support of the Armed Forces are entitled to the suspension of time provisions in section 7508 of the Code. In addition, civilian employees of the United States serving in those areas are entitled to (a) the special rule for determining surviving spouse status where the deceased spouse was in missing status as a result of service in a combat zone (sec. 2(a)(3)); (b) forgiveness of income taxes of employees dying in the combat zone or by reason of combat-zone incurred wounds (sec. 692); and (c) the special rule permitting filing of a joint return where a spouse is in missing status as a result of service in a combat zone (sec. 6013(f)(1)).

Second, the Act also provides that military personnel performing services outside of those areas but still a part of Operation Allied Force qualify for the suspension of time provisions in section 7508 of the Code during the period that hostile fire/imminent danger pay is paid with respect to those areas, provided that those services are performed both outside the United States and while deployed away from that individual's duty station.

Accordingly, the Act provides the same treatment for those serving in (or in support of) Operation Allied Force as is provided under present law to those serving in (or in support of) Operation Joint Endeavor.

Effective Date

The provision is effective on March 24, 1999 (the date on which Operation Allied Force commenced).

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

PART TWO: MISCELLANEOUS TRADE AND TECHNICAL CORRECTIONS ACT OF 1999 (PUBLIC LAW 106–36) [9]

A. Property "Subject to" a Liability Treated in the Same Manner as an Assumption of Liability (sec. 3001 of the Miscellaneous Trade and Technical Corrections Act and secs. 357 and 362 of the Code)

Present and Prior Law

A transferor of property does not recognize gain or loss if the property is exchanged solely for qualified stock in a controlled corporation (sec. 351). The assumption by the controlled corporation of a liability of the transferor (or the acquisition of property "subject to" a liability) generally does not cause the transferor to recognize gain. However, under section 357(c), the transferor does recognize gain to the extent that the sum of the assumed liabilities, together with the liabilities to which the transferred property is subject, exceeds the transferor's basis in the transferred property. If the transferred property is "subject to" a liability, Treasury regulations indicate that the amount of the liability is included in the calculation regardless of whether the underlying liability is assumed by the controlled corporation. Similar rules apply to reorganizations described in section 368(a)(1)(D).

The gain recognition rule of section 357(c) is applied separately to each transferor in a section 351 exchange.

The basis of the property in the hands of the controlled corporation equals the transferor's basis in such property, increased by the amount of gain recognized by the transferor, including section 357(c) gain.

Reasons for Change

The tax treatment under prior law was unclear in situations involving the transfer of certain liabilities. As a result, the Congress was concerned that some taxpayers may be structuring transactions to take advantage of the uncertainty. For example, where more than one asset secures a single liability, some taxpayers

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[9] H.R. 435 was referred to the House Committee on Ways and Means on February 2, 1999 and was passed by the House under suspension of the rules on February 9, 1999. No separate House Report was filed.

S. 262 was reported by the Senate Committee on Finance on February 3, 1999 (S. Rep. 106–2). On May 27, 1999, the Senate passed H.R. 435, with an amendment by Senator Snowe for Senator Roth in the nature of a substitute (Amendment No. 481). The amendment contained provisions similar to those of S. 262 as reported by the Senate Committee on Finance.

Under suspension of the rules, the House concurred with the Senate amendments to H.R. 435 on June 7, 1999.

H.R. 435 was signed by the President on June 25, 1999.

A provision substantially identical to the tax provision contained in sec. 3001 of H.R. 435 was introduced in the House of Representatives by Mr. Archer on October 19, 1998 (H.R. 4852) and was contained in the Miscellaneous Trade and Technical Corrections Act of 1998 (H.R. 4856) as passed by the House of Representatives on October 20, 1998.

might take the position that, on a transfer of the assets to different subsidiaries, each subsidiary counts the entire liability in determining the basis of the asset. This interpretation arguably might result in the duplication of tax basis or in assets having a tax basis in excess of their value, resulting in excessive depreciation deductions and mismeasurement of income. The provision is intended to eliminate the uncertainty, and to better reflect the underlying economics of these corporate transfers.

Explanation of Provision

Under the provision, the distinction between the assumption of a liability and the acquisition of an asset subject to a liability generally is eliminated. First, except as provided in Treasury regulations, a recourse liability (or any portion thereof) is treated as having been assumed if, as determined on the basis of all facts and circumstances, the transferee has agreed to, and is expected to satisfy the liability or portion thereof (whether or not the transferor has been relieved of the liability). Thus, where more than one person agrees to satisfy a liability or portion thereof, only one would be expected to satisfy such liability or portion thereof. Second, except as provided in Treasury regulations, a nonrecourse liability (or any portion thereof) is treated as having been assumed by the transferee of any asset that is subject to the liability. However, this amount is reduced in cases where an owner of other assets subject to the same nonrecourse liability agrees with the transferee to, and is expected to, satisfy the liability (up to the fair market value of the other assets, determined without regard to section 7701(g)).

In determining whether any person has agreed to and is expected to satisfy a liability, all facts and circumstances are to be considered. In any case where the transferee does agree to satisfy a liability, the transferee also will be expected to satisfy the liability in the absence of facts indicating the contrary.

In determining any increase to the basis of property transferred to the transferee as a result of gain recognized because of the assumption of liabilities under section 357, in no event will the increase cause the basis to exceed the fair market value of the property (determined without regard to sec. 7701(g)).

If gain is recognized to the transferor as the result of an assumption by a corporation of a nonrecourse liability that also is secured by any assets not transferred to the corporation, and if no person is subject to Federal income tax on such gain, then for purposes of determining the basis of assets transferred, the amount of gain treated as recognized as the result of such assumption of liability shall be determined as if the liability assumed by the transferee equaled such transferee's ratable portion of the liability, based on the relative fair market values (determined without regard to sec. 7701(g)) of all assets subject to such nonrecourse liability. In no event will the gain cause the resulting basis to exceed the fair market value of the property (determined without regard to sec. 7701(g)).

The Treasury Department has authority to prescribe such regulations as may be necessary to carry out the purposes of the provision. This authority includes the authority to specify adjustments in the treatment of any subsequent transactions involving the li-

ability, including the treatment of payments actually made with respect to any liability as well as appropriate basis and other adjustments with respect to such payments. Where appropriate, the Treasury Department also may prescribe regulations that provide that the manner in which a liability is treated as assumed under the provision is applied elsewhere in the Code.

Effective Date

The provision is effective for transfers on or after October 19, 1998. No inference regarding the tax treatment under prior law is intended.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $7 million in 1999, $12 million in 2000, $14 million in 2001, $16 million in 2002, $18 million in 2003, $20 million in 2004, $22 million in 2005, $24 million in 2006, $26 million in 2007, $28 million in 2008, $30 million in 2009, and $32 million in 2010.

PART THREE: TAX RELIEF EXTENSION ACT OF 1999 (PUBLIC LAW 106–170) [10]

I. EXTENSION OF EXPIRING TAX PROVISIONS

A. Extend Minimum Tax Relief for Individuals (sec. 501 of the Tax Relief Extension Act and secs. 24 and 26 of the Code)

Present and Prior Law

Present and prior law provides for certain nonrefundable personal tax credits (i.e., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child tax credit, the credit for interest on certain home mortgages, the HOPE Scholarship and Lifetime Learning credits, and the D.C. homebuyer's credit). Under prior law, except for taxable years beginning during 1998, these credits were allowed only to the extent that the individual's regular income tax liability exceeds the individual's tentative minimum tax, determined without regard to the minimum tax foreign tax credit; for taxable years beginning during 1998, these credits were allowed to the extent of the full amount of the individual's regular tax (without regard to the tentative minimum tax).

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

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[10] The Tax Relief Extension Act was enacted as Title V of the Ticket to Work and Work Incentives Improvement Act of 1999 (H.R. 1180). For legislative background, see H.R. 2923, as reported by the House Ways and Means Committee, H. Rep. 106–344 (September 28, 1999); S. 1792, as reported by the Senate Finance Committee, S. Rep. 106–201 (October 26, 1999); and Title V of H.R. 1180, H. Rep. 106–478 (Joint Explanatory Statement of the Committee on Conference) (November 17, 1999). Reasons for change appearing in this document for the provisions in this Act are taken from H. Rep. 106–344 or S. Rep. 106–201 unless otherwise indicated.

For families with three or more qualifying children, a refundable child credit is provided, up to the amount by which the liability for social security taxes exceeds the amount of the earned income credit (sec. 24(d)). Under prior law, for taxable years beginning after 1998, the refundable child credit was reduced by the amount of the individual's minimum tax liability (i.e., the amount by which the tentative minimum tax exceeds the regular tax liability).

Reasons for Change

The Congress believed that middle-income families should be able to use the nonrefundable credits without limitation by reason of the minimum tax. This provision will result in significant simplification by reducing the number of individuals required to make AMT computations for purposes of determining their personal credits.

Explanation of Provision

The Tax Relief Extension Act extends the provision that allows the nonrefundable credits to offset the individual's regular tax liability in full (as opposed to only the amount by which the regular tax exceeds the tentative minimum tax) to taxable years beginning in 1999. For taxable years beginning in 2000 and 2001 the personal nonrefundable credits may offset both the regular tax and the minimum tax.[11]

Under the Tax Relief Extension Act, the refundable child credit will not be reduced by the amount of an individual's minimum tax in taxable years beginning in 1999, 2000, and 2001.

Effective Date

The provisions apply to taxable years beginning in 1999, 2000, and 2001.

Revenue Effect

The provisions are estimated to reduce Federal fiscal year budget receipts by $972 million in 2000, $977 million in 2001, and $943 million in 2002.

B. Extension of Research Tax Credit (sec. 502 of the Tax Relief Extension Act and sec. 41 of the Code)

Present and Prior Law

Section 41 provides for a research tax credit equal to 20 percent of the amount by which a taxpayer's qualified research expenditures for a taxable year exceeded its base amount for that year. The research tax credit expired and generally does not apply to amounts paid or incurred after June 30, 1999.

Except for certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenditures for the current taxable year exceed its base amount. The base amount for the current

[11] The foreign tax credit will be allowed before the personal credits in computing the regular tax for these years.

year generally is computed by multiplying the taxpayer's "fixed-base percentage" by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenditures and had gross receipts during each of at least three years from 1984 through 1988, then its "fixed-base percentage" is the ratio that its total qualified research expenditures for the 1984–1988 period bears to its total gross receipts for that period (subject to a maximum ratio of .16). All other taxpayers (so-called "start- up firms") are assigned a fixed-base percentage of 3.0 percent. Expenditures attributable to research that is conducted outside the United States do not enter into the credit computation.

Taxpayers are allowed to elect an alternative incremental research credit regime. If a taxpayer elects to be subject to this alternative regime, the taxpayer is assigned a three-tiered fixed-base percentage (that is lower than the fixed-base percentage otherwise applicable under present law) and the credit rate likewise is reduced. Under the alternative credit regime, a credit rate of 1.65 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1 percent (i.e., the base amount equals 1 percent of the taxpayer's average gross receipts for the four preceding years) but do not exceed a base amount computed by using a fixed-base percentage of 1.5 percent. A credit rate of 2.2 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1.5 percent but do not exceed a base amount computed by using a fixed-base percentage of 2 percent. A credit rate of 2.75 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 2 percent. An election to be subject to this alternative incremental credit regime may be made for any taxable year beginning after June 30, 1996, and such an election applies to that taxable year and all subsequent years (in the event that the credit subsequently is extended by Congress) unless revoked with the consent of the Secretary of the Treasury.

Reasons for Change

The Congress believed that increasing technological knowledge ultimately will lead to new and better products produced at lower costs. New and better products and lower production costs are the genesis of economic growth. For this reason, the Congress believed it was important to extend the research and experimentation tax credit.

In addition, the Congress believed the alternative incremental credit enacted in 1996 should be strengthened. The alternative incremental research credit was enacted to respond to the changing economic circumstances of many taxpayers, which invest heavily in research. However, the Congress believed that, under current law, the alternative incremental research credit provides less of a research incentive than does the regular research and experimentation tax credit. Therefore, the Congress believed it was appropriate to increase the rate of the alternative incremental research credit.

Lastly, the Congress believed that qualified research expenditures incurred in Puerto Rico and other possessions should qualify for purposes of determination of the research credit, so long as such expenses are not otherwise related to credits allowable under sec. 30A ("Puerto Rico economic activity credit") or under sec. 936 ("Puerto Rico and possession tax credit").

Explanation of Provision

The provision extends the research credit through June 30, 2004.

In addition, the provision increases the credit rate applicable under the alternative incremental research credit by one percentage point per step. The provision also expands the definition of qualified research to include research undertaken in Puerto Rico and possessions of the United States.

Research tax credits that are attributable to the period beginning on July 1, 1999, and ending on September 30, 2000, may not be taken into account in determining any amount required to be paid for any purpose under the Internal Revenue Code prior to October 1, 2000. On or after October 1, 2000, such credits may be taken into account through the filing of an amended return, an application for expedited refund, an adjustment of estimated taxes, or other means that are allowed by the Code. The prohibition on taking credits attributable to the period beginning on July 1, 1999, and ending on September 30, 2000, into account as payments prior to October 1, 2000, extends to the determination of any penalty or interest under the Code. For example, the amount of tax required to be shown on a return that is due prior to October 1, 2000 (excluding extensions) may not be reduced by any such credits. In addition, the Congress clarified that deductions under section 174 are reduced by credits allowable under section 41 as under present law, not withstanding the delay in taking the credit into account created by this provision.

Similarly, research tax credits that are attributable to the period beginning October 1, 2000, and ending on September 30, 2001, may not be taken into account in determining any amount required to be paid for any purpose under the Internal Revenue Code prior to October 1, 2001. On or after October 1, 2001, such credits may be taken into account through the filing of an amended return, an application for expedited refund, an adjustment of estimated taxes, or other means that are allowed by the Code. Likewise, the prohibition on taking credits attributable to the period beginning on October 1, 2000, and ending on September 30, 2001, into account as payments prior to October 1, 2001, extends to the determination of any penalty or interest under the Code.

In extending the research credit, the Congress expressed concern that the definition of qualified research be administered in a manner that is consistent with the intent Congress has expressed in enacting and extending the research credit. The Congress urged the Secretary to consider carefully the comments he had and may receive regarding the proposed regulations relating to the computation of the credit under section 41(c) and the definition of qualified research under section 41(d), particularly regarding the "common knowledge" standard. The Congress further noted the rapid pace of technological advance, especially in service-related industries, and

urged the Secretary to consider carefully the comments he had and may receive in promulgating regulations in connection with what constitutes "internal use" with regard to software expenditures. The Congress also observed that software research, that otherwise satisfies the requirements of section 41, which is undertaken to support the provision of a service, should not be deemed "internal use" solely because the business component involves the provision of a service.

The Congress reaffirmed that qualified research is research undertaken for the purpose of discovering new information, which is technological in nature. For purposes of applying this definition, new information is information that is new to the taxpayer, is not freely available to the general public, and otherwise satisfies the requirements of section 41. Employing existing technologies in a particular field or relying on existing principles of engineering or science is qualified research, if such activities are otherwise undertaken for purposes of discovering information and satisfy the other requirements under section 41.

The Congress also was concerned about unnecessary and costly taxpayer record keeping burdens and reaffirm that eligibility for the credit is not intended to be contingent on meeting unreasonable record keeping requirements.

Effective Date

The extension of the research credit is effective for qualified research expenditures paid or incurred during the period July 1, 1999, through June 30, 2004. The increase in the credit rate under the alternative incremental research credit is effective for taxable years beginning after June 30, 1999.

Revenue Effect

The provision is estimated to reduce Federal fiscal year receipts by $1,661 million in 2001, $4,082 million in 2002, $2,541 million in 2003, $2,242 million in 2004, $1,343 million in 2005, $708 million in 2006, $386 million in 2007, $150 million in 2008, and $26 million in 2009.

C. Subpart F Exemption for Active Financing Income (sec. 503 of the Tax Relief Extension Act and secs. 953 and 954 of the Code)

Present and Prior Law

Under the subpart F rules, 10-percent U.S. shareholders of 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 (Prop. 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"). These exceptions are applicable only for taxable years beginning in 1999.[12]

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 a temporary exception 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, certain temporary exceptions from insurance income and from foreign personal

[12] Temporary exceptions from the subpart F provisions for certain active financing income applied only for taxable years beginning in 1998. Those exceptions were extended and modified as part of the present-law provision.

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

In the Taxpayer Relief Act of 1997, one-year temporary exceptions from foreign personal holding company income were enacted[13] for income from the active conduct of an insurance, banking, financing, or similar business. In the Tax and Trade Relief Extension Act of 1998 (the "1998 Act"),[14] the Congress extended the temporary exceptions for an additional year, with certain modifications designed to treat various types of businesses with active financing income more similarly to each other than did the 1997 provision. The Congress believed that it was appropriate to extend the temporary exceptions, as modified in the 1998 Act, for another two years.

Explanation of Provision

The provision extends for two years the present-law temporary exceptions from subpart F foreign personal holding company income, foreign base company services income, and insurance income 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.

The Congress clarified that if the temporary exception from subpart F insurance income does not apply for a taxable year beginning after December 31, 2001, section 953(a) is to be applied to such taxable year in the same manner as it would for a taxable year beginning in 1998 (i.e., under the law in effect before amendments to section 953(a) were made in 1998).[15] Thus, for future periods in which the temporary exception relating to insurance income is not in effect, the same-country exception from subpart F insurance income applies as under prior law.

Effective Date

The provision is effective for taxable years of foreign corporations beginning after December 31, 1999, and before January 1, 2002, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

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[13] The President canceled this provision in 1997 pursuant to the Line Item Veto Act. On June 25, 1998, the U.S. Supreme Court held that the cancellation procedures set forth in the Line Item Veto Act are unconstitutional. *Clinton v. City of New York,* 118 S. Ct. 2091 (June 25, 1998).

[14] The Tax and Trade Relief Extension Act of 1998, Division J, Making Omnibus Consolidated and Emergency Supplemental Appropriations for Fiscal Year 1999, P.L. 105–277, sec. 1005, 112 Stat. 2681 (1998).

[15] Id.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $187 million in 2000, $785 million in 2001, and $744 million in 2002.

D. Taxable Income Limit on Percentage Depletion for Marginal Production (sec. 504 of the Tax Relief Extension Act and sec. 613A of the Code)

Present Law

In general

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

Two methods of depletion are allowable under the Code: (1) the cost depletion method, and (2) the percentage depletion method (secs. 611–613). Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the depletable property which is equal to the ratio of units sold from that property during the taxable year to the number of units remaining as of the end of taxable year plus the number of units sold during the taxable year. Thus, the amount recovered under cost depletion may never exceed the taxpayer's basis in the property.

Under the percentage depletion method, generally, 15 percent of the taxpayer's gross income from an oil- or gas-producing property is allowed as a deduction in each taxable year (sec. 613A(c)). The amount deducted generally may not exceed 100 percent of the net income from that property in any year (the "net-income limitation") (sec. 613(a)). The Taxpayer Relief Act of 1997 suspended the 100–percent-of-net-income limitation for production from marginal wells for taxable years beginning after December 31, 1997, and before January 1, 2000. Additionally, the percentage depletion deduction for all oil and gas properties may not exceed 65 percent of the taxpayer's overall taxable income (determined before such deduction and adjusted for certain loss carrybacks and trust distributions) (sec. 613A(d)(1)).[16] Because percentage depletion, unlike cost depletion, is computed without regard to the taxpayer's basis in the depletable property, cumulative depletion deductions may be greater than the amount expended by the taxpayer to acquire or develop the property.

A taxpayer is required to determine the depletion deduction for each oil or gas property under both the percentage depletion method (if the taxpayer is entitled to use this method) and the cost de-

[16] Amounts disallowed as a result of this rule may be carried forward and deducted in subsequent taxable years, subject to the 65-percent taxable income limitation for those years.

pletion method. If the cost depletion deduction is larger, the taxpayer must utilize that method for the taxable year in question (sec. 613(a)).

Limitation of oil and gas percentage depletion to independent producers and royalty owners

Generally, only independent producers and royalty owners (as contrasted to integrated oil companies) are allowed to claim percentage depletion. Percentage depletion for eligible taxpayers is allowed only with respect to up to 1,000 barrels of average daily production of domestic crude oil or an equivalent amount of domestic natural gas (sec. 613A(c)). For producers of both oil and natural gas, this limitation applies on a combined basis.

In addition to the independent producer and royalty owner exception, certain sales of natural gas under a fixed contract in effect on February 1, 1975, and certain natural gas from geopressured brine, are eligible for percentage depletion, at rates of 22 percent and 10 percent, respectively. These exceptions apply without regard to the 1,000-barrel-per-day limitation and regardless of whether the producer is an independent producer or an integrated oil company.

Reasons for Change

The Congress noted that oil is, and will continue to be, vital to the American economy. The Congress observed that low oil prices had created substantial economic hardship in the oil industry and particularly in those communities where the majority of jobs are related to providing this vital commodity to the nation. Skilled workers and industry know-how will be critical to the exploration for and production of oil and gas in the future. The Congress, therefore, was concerned that economic hardship in the industry could lead to business failures and job losses.

Explanation of Provision

The provision extends the period when the 100-percent net-income limit is suspended to include taxable years beginning after December 31, 1999 and before January 1, 2002.

Effective Date

The provision became effective on the date of enactment (December 17, 1999).

Revenue Effect

The provision is estimated to reduce Federal fiscal year revenues by $23 million in 2000, by $35 million in 2001, and by $12 million in 2002.

E. Extend the Work Opportunity Tax Credit (sec. 505 of the Tax Relief Extension Act and sec. 51 of the Code)

Present and Prior Law

In general

The work opportunity tax credit ("WOTC"), which expired on June 30, 1999, was available on an elective basis for employers hiring individuals from one or more of eight targeted groups. The credit equals 40 percent (25 percent for employment of 400 hours or less) of qualified wages. Generally, qualified wages are wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer.

The maximum credit per employee is $2,400 (40% of the first $6,000 of qualified first-year wages). With respect to qualified summer youth employees, the maximum credit is $1,200 (40 percent of the first $3,000 of qualified first-year wages).

The employer's deduction for wages is reduced by the amount of the credit.

Targeted groups eligible for the credit

The eight targeted groups are: (1) families eligible to receive benefits under the Temporary Assistance for Needy Families (TANF) Program; (2) high-risk youth; (3) qualified ex-felons; (4) vocational rehabilitation referrals; (5) qualified summer youth employees; (6) qualified veterans; (7) families receiving food stamps; and (8) persons receiving certain Supplemental Security Income (SSI) benefits.

Minimum employment period

No credit is allowed for wages paid to employees who work less than 120 hours in the first year of employment.

Expiration date

The credit was effective for wages paid or incurred to a qualified individual who began work for an employer before July 1, 1999.

Reasons for Change

The Congress believed the preliminary experience of the WOTC is promising as an incentive for employers to hire individuals who are under-skilled, undereducated, or who generally may be less desirable (e.g., lacking in work experience) to employers. A temporary extension of this credit will allow the Congress and the Treasury and Labor Departments to continue to monitor the effectiveness of the credit. The Congress also believed that the electronic filing of the request for certification (the "Form 8850") will reduce the administrative burden involved in claiming the credit and encourage more employers to participate in the program.

Explanation of Provision

The Tax Relief Extension Act provides for a 30-month extension of the work opportunity tax credit (through December 31, 2001) and includes a clarification of the definition of first year of employ-

ment for purposes of the WOTC. Also, the Tax Relief Extension Act directed the Secretary of the Treasury to expedite the use of electronic filing of requests for certification under the credit.

Effective Date

The provision is effective for wages paid or incurred to qualified individuals who begin work for the employer on or after July 1, 1999, and before January 1, 2002.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $229 million in 2000, $321 million in 2001, $293 million in 2002, $151 million in 2003, $58 million in 2004, $19 million in 2005, and $3 million in 2006.

F. Extend the Welfare-To-Work Tax Credit (sec. 505 of the Tax Relief Extension Act and sec. 51A of the Code)

Present and Prior Law

The Code provided to employers a tax credit on the first $20,000 of eligible wages paid to qualified long-term family assistance (AFDC or its successor program) recipients during the first two years of employment. The credit is 35 percent of the first $10,000 of eligible wages in the first year of employment and 50 percent of the first $10,000 of eligible wages in the second year of employment. The maximum credit is $8,500 per qualified employee.

Qualified long-term family assistance recipients are: (1) members of a family that has received family assistance for at least 18 consecutive months ending on the hiring date; (2) members of a family that has received family assistance for a total of at least 18 months (whether or not consecutive) after the date of enactment of this credit if they are hired within 2 years after the date that the 18-month total is reached; and (3) members of a family who are no longer eligible for family assistance because of either Federal or State time limits, if they are hired within 2 years after the Federal or State time limits made the family ineligible for family assistance.

Eligible wages include cash wages paid to an employee plus amounts paid by the employer for the following: (1) educational assistance excludable under a section 127 program (or that would be excludable but for the expiration of sec. 127); (2) health plan coverage for the employee, but not more than the applicable premium defined under section 4980B(f)(4); and (3) dependent care assistance excludable under section 129.

The welfare to work credit was effective for wages paid or incurred to a qualified individual who begins work for an employer on or after January 1, 1998, and before July 1, 1999.

Reasons for Change

When enacted in the Taxpayer Relief Act of 1997, the goals of the welfare-to-work credit were: (1) to provide an incentive to hire long-term welfare recipients; (2) to promote the transition from welfare to work by increasing access to employment; and (3) to en-

courage employers to provide these individuals with training, health coverage, dependent care and ultimately better job attachment. The Congress believed that the credit should be temporarily extended to provide the Congress and the Treasury and Labor Departments a better opportunity to assess the operation and effectiveness of the credit in meeting its goals.

Explanation of Provision

The Tax Relief Extension Act provides for a 30-month extension of the welfare-to-work tax credit (through December 31, 2001).

Effective Date

The provision is effective for wages paid or incurred to a qualified individual who begins work for an employer on or after July 1, 1999, and before January 1, 2002.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $49 million in 2000, $77 million in 2001, $79 million in 2002, $47 million in 2003, $19 million in 2004, $7 million in 2005, and $2 million in 2006.

G. Extend Exclusion for Employer-Provided Educational Assistance (sec. 506 of the Tax Relief Extension Act and sec. 127 of the Code)

Present and Prior Law

Educational expenses paid by an employer for the employer's employees are generally deductible to the employer.

Employer-paid educational expenses are excludable from the gross income and wages of an employee if provided under a section 127 educational assistance plan or if the expenses qualify as a working condition fringe benefit under section 132. Section 127 provides an exclusion of $5,250 annually for employer-provided educational assistance. Under prior law, the exclusion expired with respect to graduate-level courses beginning after June 30, 1996. With respect to undergraduate-level courses, the exclusion for employer-provided educational assistance expired under prior law with respect to courses beginning on or after June 1, 2000.

In order for the exclusion to apply, certain requirements must be satisfied. The educational assistance must be provided pursuant to a separate written plan of the employer. The educational assistance program must not discriminate in favor of highly compensated employees. In addition, not more than 5 percent of the amounts paid or incurred by the employer during the year for educational assistance under a qualified educational assistance plan can be provided for the class of individuals consisting of more than 5-percent owners of the employer (and their spouses and dependents).

Educational expenses that do not qualify for the section 127 exclusion may be excludable from income as a working condition

fringe benefit.[17] In general, education qualifies as a working condition fringe benefit if the employee could have deducted the education expenses under section 162 if the employee paid for the education. In general, education expenses are deductible by an individual under section 162 if the education (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, applicable law or regulations imposed as a condition of continued employment. However, education expenses are generally not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business.[18]

Reasons for Change

The Congress believed that the exclusion for employer-provided educational assistance has enabled millions of workers to advance their education and improve their job skills without incurring additional taxes and a reduction in take-home pay. In addition, the exclusion lessens the complexity of the tax laws. Without the special exclusion, a worker receiving educational assistance from his or her employer is subject to tax on the assistance, unless the education is related to the worker's current job. Because the determination of whether particular educational assistance is job-related is based on the facts and circumstances, it may be difficult to determine with certainty whether the educational assistance is excludable from income. This uncertainty may lead to disputes between taxpayers and the Internal Revenue Service.

The past experience of allowing the exclusion to expire and subsequently retroactively extending it has created burdens for employers and employees. Employees may have difficulty planning for their educational goals if they do not know whether their tax bills will increase. For employers, the fits and starts of the legislative history of the provision have caused severe administrative problems. The Congress believed that uncertainty about the exclusion's future may discourage some employers from providing educational benefits. Thus, the Congress believed it appropriate to extend the provisions so that employers and employees can plan for some time into the future.

Explanation of Provision

The Tax Relief Extension Act extends the exclusion for employer-provided educational assistance through December 31, 2001. The exclusion does not apply with respect to graduate-level courses.

Effective Date

The provision is effective with respect to courses beginning after May 31, 2000, and before January 1, 2002.

[17] These rules also apply in the event that section 127 expires and is not reinstated.

[18] In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses, along with other miscellaneous deductions, exceed 2 percent of the taxpayer's AGI. The 2-percent floor limitation is disregarded in determining whether an item is excludable as a working condition fringe benefit.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $134 million in 2000, $318 million in 2001, and $132 million in 2002.

H. Extension and Modification of Credit for Producing Electricity From Certain Renewable Resources (sec. 507 of the Tax Relief Extension Act and sec. 45 of the Code)

Present and Prior Law

An income tax credit is allowed for the production of electricity from either qualified wind energy or qualified "closed-loop" biomass facilities (sec. 45).

The credit applies to electricity produced by a qualified wind energy facility placed in service after December 31, 1993, and before July 1, 1999, and to electricity produced by a qualified closed-loop biomass facility placed in service after December 31, 1992, and before July 1, 1999. The credit is allowable for production during the 10-year period after a facility is originally placed in service.

Closed-loop biomass is the use of plant matter, where the plants are grown for the sole purpose of being used to generate electricity. It does not include the use of waste materials (including, but not limited to, scrap wood, manure, and municipal or agricultural waste). The credit also is not available to taxpayers who use standing timber to produce electricity. In order to claim the credit, a taxpayer must own the facility and sell the electricity produced by the facility to an unrelated party.

The credit for electricity produced from wind or closed-loop biomass is a component of the general business credit (sec. 28(b)(1)). This credit, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability above $25,000 or (2) the tentative minimum tax. An unused general business credit generally may be carried back one taxable year and carried forward 20 taxable years (sec. 39).

Reasons for Change

The Congress believed that the credit provided under section 45 has been important to the development of environmentally friendly, renewable wind power and that extending the placed in service date will increase the further development of wind resources.

The Congress observed, however, that there is organic waste that is disposed of in an uncontrolled manner. Such organic waste can be a fuel source that, if utilized, can promote a cleaner environment. The Congress believed that providing a credit to utilize these organic fuel sources can help produce needed electricity while providing environmental benefits for communities and the nation.

Explanation of Provision

The provision extends the present-law tax credit for electricity produced by wind and closed-loop biomass for facilities placed in

service after June 30, 1999, and before January 1, 2002. The provision also modifies the tax credit to include electricity produced from poultry litter, for facilities placed in service after December 31, 1999, and before January 1, 2002. In addition, the provision clarifies which wind facilities are eligible for the credit.

Effective Date

The provision is effective on the date of enactment (December 17, 1999).

Revenue Effect

The provision is estimated to reduce Federal fiscal year receipts by $9 million in 2000, $25 million in 2001, $33 million in 2002, $33 million in 2003, $34 million in 2004, $35 million in 2005, $36 million in 2006, $37 million in 2007, $38 million in 2008, $38 million in 2009, and $39 million in 2010.

I. Extension of Authority to Issue Qualified Zone Academy Bonds (sec. 509 of the Tax Relief Extension Act and sec. 1397E of the Code)

Present and Prior Law

Tax-exempt bonds

Interest on State and local governmental bonds generally is excluded from gross income for Federal income tax purposes if the proceeds of the bonds are used to finance direct activities of these governmental units or if the bonds are repaid with revenues of the governmental units, including the financing of public schools (sec. 103).

Qualified zone academy bonds

As an alternative to traditional tax-exempt bonds, States and local governments are given the authority to issue "qualified zone academy bonds" ("QZABs") (sec. 1397E). A total of $400 million of qualified zone academy bonds could be issued in each of 1998 and 1999. The $400 million aggregate bond cap is allocated each year to the States according to their respective populations of individuals below the poverty line. Each State, in turn, allocates the credit authority to qualified zone academies within such State. Under prior law, a State could carry over any unused allocation indefinitely into subsequent years.

Certain financial institutions that hold qualified zone academy bonds are entitled to a nonrefundable tax credit in an amount equal to a credit rate multiplied by the face amount of the bond. A taxpayer holding a qualified zone academy bond on the credit allowance date is entitled to a credit. The credit is includable in gross income (as if it were a taxable interest payment on the bond), and may be claimed against regular income tax and AMT liability.

The Treasury Department sets the credit rate at a rate estimated to allow issuance of qualified zone academy bonds without discount and without interest cost to the issuer. The maximum term of the bond is determined by the Treasury Department, so that the

present value of the obligation to repay the bond is 50 percent of the face value of the bond.

"Qualified zone academy bonds" are defined as any bond issued by a State or local government, provided that (1) at least 95 percent of the proceeds are used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a "qualified zone academy" and (2) private entities have promised to contribute to the qualified zone academy certain equipment, technical assistance or training, employee services, or other property or services with a value equal to at least 10 percent of the bond proceeds.

A school is a "qualified zone academy" if (1) the school is a public school that provides education and training below the college level, (2) the school operates a special academic program in cooperation with businesses to enhance the academic curriculum and increase graduation and employment rates, and (3) either (a) the school is located in an empowerment zones enterprise community designated under the Code, or (b) it is reasonably expected that at least 35 percent of the students at the school will be eligible for free or reduced-cost lunches under the school lunch program established under the National School Lunch Act.

Explanation of Provision

The provision authorized up to $400 million of qualified zone academy bonds to be issued in each of calendar years 2000 and 2001. Unused QZAB authority arising in 1998 and 1999 may be carried forward by the State or local government entity to which it is (or was) allocated for up to three years after the year in which the authority originally arose. Unused QZAB authority arising in 2000 and 2001 may be carried forward for two years after the year in which it arises. Each issuer is deemed to use the oldest QZAB authority that has been allocated to it first when new bonds are issued.

Effective Date

The provision became effective on the date of enactment (December 17, 1999).

Revenue Effect

The provision is estimated to reduce Federal fiscal year revenues by $3 million in 2000, $11 million in 2001, $20 million in 2002, $28 million in 2003, $30 million annually in 2004 through 2010.

J. Extend the Tax Credit for First-Time D.C. Homebuyers (sec. 510 of the Tax Relief Extension Act and sec. 1400C of the Code)

Present and Prior Law

First-time homebuyers of a principal residence in the District of Columbia are eligible for a nonrefundable tax credit of up to $5,000 of the amount of the purchase price. The $5,000 maximum credit applies both to individuals and married couples. Married individuals filing separately can claim a maximum credit of $2,500 each.

The credit phases out for individual taxpayers with adjusted gross income between $70,000 and $90,000 ($110,000–$130,000 for joint filers). For purposes of eligibility, a "first-time homebuyer" means any individual if such individual did not have a present ownership interest in a principal residence in the District of Columbia in the one-year period ending on the date of the purchase of the residence to which the credit applies. Under prior law, the credit was scheduled to expire for residences purchased after December 31, 2000.

Explanation of Provision

The provision extends the tax credit for first-time D.C. homebuyers for one year (so that it applies to residences purchased on or before December 31, 2001).[19]

Effective Date

The provision is effective for residences purchased after December 31, 2000 and before January 1, 2002.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $5 million in 2001, $15 million in 2002, and less than $500,000 in each of the years 2003 through 2010.

K. Extend Expensing of Environmental Remediation Expenditures (sec. 511 of the Tax Relief Extension Act and sec. 198 of the Code)

Present and Prior Law

Taxpayers can elect to treat certain environmental remediation expenditures that would otherwise be chargeable to capital account as deductible in the year paid or incurred (sec. 198). The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site.

A "qualified contaminated site" generally is any property that (1) is held for use in a trade or business, for the production of income, or as inventory; (2) is certified by the appropriate State environmental agency to be located within a targeted area; and (3) contains (or potentially contains) a hazardous substance (so-called "brownfields"). Targeted areas are defined as: (1) empowerment zones and enterprise communities as designated under present law; (2) sites announced before February, 1997, as being subject to one of the 76 Environmental Protection Agency ("EPA") Brownfields Pilots; (3) any population census tract with a poverty rate of 20 percent or more; and (4) certain industrial and commercial areas that are adjacent to tracts described in (3) above. However, sites that are identified on the national priorities list under the Comprehen-

[19] A subsequent provision described below in Part Eight (sec. 164 of H.R. 5662, The Community Renewal Tax Relief Act of 2000) extends the D.C. homebuyer credit for an additional two years (through December 31, 2003).

sive Environmental Response, Compensation, and Liability Act of 1980 cannot qualify as targeted areas.

Eligible expenditures are those paid or incurred before January 1, 2001.

Reasons for Change

Report of Senate Committee on Finance[20]

The Committee would like to see more so-called “brownfield” sites brought back into productive use in the economy. Cleaning up such sites mitigates potential harms to public health and can help revitalize affected communities. The Committee seeks to encourage the clean up of contaminated sites. To achieve this goal, the Committee believes it is necessary to expand the set of brownfield sites that may claim the tax benefits of expending beyond the relatively narrow class of sites identified in the Taxpayer Relief Act of 1997.

Explanation of Provision

The provision extends the present-law expiration date for sec. 198 to include those expenditures paid or incurred before January 1, 2002.

Effective Date

The provision to extend the expiration date is effective upon the date of enactment (December 17, 1999).

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $11 million in 2000, to reduce Federal fiscal year budget receipts by $43 million in 2001, $59 million in 2002, $20 million in 2003, $2 million in 2004, $1 million in 2005, and to increase Federal fiscal year budget receipts by $2 million in 2006, $5 million in 2007, $6 million in 2008, $8 million in 2009, and $10 million in 2010.

L. Temporary Increase in Amount of Rum Excise Tax Covered Over to Puerto Rico and the Virgin Islands (sec. 512 of the Tax Relief Extension Act and sec. 7652 of the Code)

Present and Prior Law

A $13.50 per proof gallon[21] excise tax is imposed on distilled spirits produced in, or imported or brought into, the United States (sec. 5001). The excise tax does not apply to distilled spirits that are exported from the United States or to distilled spirits that are

[20] H.R. 1180 as passed by the House and amended by the Senate did not contain any provision relating to sec. 198. However, S. 1792, as passed by the Senate, would have eliminated the targeted area requirement, thereby, expanding eligible sites to include any site containing (or potentially containing) a hazardous substance that is certified by the appropriate State environmental agency, but not those sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980. The conference agreement did not adopt the provision of S. 1792, but, as explained below, extended the date by which qualifying expenditures are to be incurred. The reasons for change reported here reprint the reasons for change reported in the committee report accompanying S. 1792 (S. Rep. 106–201, 17).

[21] A proof gallon is a liquid gallon consisting of 50 percent alcohol.

consumed in U.S. possessions (e.g., Puerto Rico and the Virgin Islands).

Under present and prior law the Code provides for payment ("coverover") of $10.50 per proof gallon of the excise tax imposed on rum imported (or brought) into the United States (without regard to the country of origin) to Puerto Rico and the Virgin Islands (sec. 7652). During the five-year period ending on September 30, 1998, the amount covered over was $11.30 per proof gallon. This temporary increase was enacted in 1993 as transitional relief accompanying a reduction in certain tax benefits for corporations operating in Puerto Rico and the Virgin Islands (sec. 936).

Amounts covered over to Puerto Rico and the Virgin Islands are deposited in the treasuries of the two possessions for use as those possessions determine.

Reasons for Change

The Congress found that the fiscal needs of Puerto Rico and the Virgin Islands remained substantial and, therefore, found it appropriate to increase and extend the coverover of excise tax receipts to Puerto Rico and the Virgin Islands.

Explanation of Provision

The provision increases the rum excise tax coverover to a rate of $13.25 per proof gallon during the period from July 1, 1999, through December 31, 2001.

The provision also includes a special rule for payment of the $2.75 per proof gallon increase in the coverover rate for Puerto Rico and the Virgin Islands. The rule applies to payments that otherwise would have been made in Fiscal Year 2000. Under this rule, amounts attributable to the increase in the coverover rate that would have been transferred to Puerto Rico and the Virgin Islands after June 30, 1999 and before the date of the provision's enactment, were to be paid on the date which was 15 days after the date of enactment. However, the total amount of this initial payment (aggregated for both possessions) could not exceed $20 million.[22]

The next payment to Puerto Rico and the Virgin Islands with respect to the $2.75 increase in the coverover rate was to be made on October 1, 2000. This payment was to equal the total amount attributable to the increase that otherwise would have be transferred to Puerto Rico and the Virgin Islands before October 1, 2000 (less the payment of up to $20 million made 15 days after the date of enactment).

Payments for the remainder of the period through December 31, 2001, are to be paid as provided under the present- and prior-law rules for the $10.50 per proof gallon coverover rate.

The special payment rule does not affect payments to Puerto Rico and the Virgin Islands with respect to the permanent $10.50 per proof gallon coverover rate.

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[22] This limitation subsequently was repealed by the Trade and Development Act of 2000.

Effective Date

The provision became effective on the date of enactment (December 17, 1999).

Revenue Effect

The provision is estimated to increase Federal fiscal year budget outlays by $21 million in 2000, $115 million in 2002, and $15 million in 2003.

II. OTHER TIME-SENSITIVE PROVISIONS

A. Prohibit Disclosure of APAs and APA Background Files (sec. 521 of the Tax Relief Extension Act and secs. 6103 and 6110 of the Code)

Present and Prior Law

Section 6103

Under present and prior law, returns and return information are confidential and cannot be disclosed unless authorized by the Internal Revenue Code.

The Code defines "return information" broadly. Under present and prior law, return information includes:

(1) a taxpayer's identity, the nature, source or amount of income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld, deficiencies, overassessments, or tax payments;

(2) whether the taxpayer's return was, is being, or will be examined or subject to other investigation or processing; or

(3) any other data, received by, recorded by, prepared by, furnished to, or collected by the Secretary with respect to a return or with respect to the determination of the existence, or possible existence, of liability (or the amount thereof) of any person under this title for any tax, penalty, interest, fine, forfeiture, or other imposition, or offense,[23] and

(4) any part of any written determination or any background file document relating to such written determination which is not open to public inspection under section 6110.[24]

Section 6110 and the Freedom of Information Act

With certain exceptions, present and prior law makes the text of any written determination the Internal Revenue Service ("IRS") issues available for public inspection. Once the IRS makes the written determination publicly available, the background file documents associated with such written determination are available for public inspection upon written request. The Code defines "background file documents" as any written material submitted in support of the request. Background file documents also include any communications between the IRS and persons outside the IRS concerning such written determination that occur before the IRS issues the determination.

Before making them available for public inspection, section 6110 requires the IRS to delete specific categories of sensitive information from the written determination and background file documents.[25] It also provides judicial and administrative procedures to resolve disputes over the scope of the information the IRS will disclose. In addition, Congress has also wholly exempted certain matters from section 6110's public disclosure requirements.[26] Any part

[23] Sec. 6103(b)(2)(A).
[24] Sec. 6103(b)(2)(B).
[25] Sec. 6110(c) provides for the deletion of identifying information, trade secrets, confidential commercial and financial information and other material.
[26] Sec. 6110(l).

of a written determination or background file that is not disclosed under section 6110 constitutes "return information." [27]

The Freedom of Information Act (FOIA) lists categories of information that a federal agency must make available for public inspection.[28] It establishes a presumption that agency records are accessible to the public. The FOIA, however, also provides nine exemptions from public disclosure. One of those exemptions is for matters specifically exempted from disclosure by a statute other than the FOIA if the exempting statute meets certain requirements.[29] Section 6103 qualifies as an exempting statute under this FOIA provision. Thus, returns and return information that section 6103 deems confidential are exempt from disclosure under the FOIA.

Section 6110 is the exclusive means for the public to view IRS written determinations.[30] If section 6110 covers the written determination, then the public cannot use the FOIA to obtain that determination.

Advance Pricing Agreements

The Advanced Pricing Agreement ("APA") program is an alternative dispute resolution program conducted by the IRS, which resolves international transfer pricing issues prior to the filing of the corporate tax return. Specifically, an APA is an advance agreement establishing an approved transfer pricing methodology entered into among the taxpayer, the IRS, and a foreign tax authority. The IRS and the foreign tax authority generally agree to accept the results of such approved methodology. Alternatively, an APA also may be negotiated between just the taxpayer and the IRS; such an APA establishes an approved transfer pricing methodology for U.S. tax purposes. The APA program focuses on identifying the appropriate transfer pricing methodology; it does not determine a taxpayer's tax liability. Taxpayers voluntarily participate in the program.

To resolve the transfer pricing issues, the taxpayer submits detailed and confidential financial information, business plans and projections to the IRS for consideration. Resolution involves an extensive analysis of the taxpayer's functions and risks.

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[27] Sec. 6103(b)(2)(B) ("The term 'return information' means . . . any part of any written determination or any background file document relating to such written determination (as such terms are defined in section 6110(b)) which is not open to public inspection under section 6110").

[28] Unless published promptly and offered for sale, an agency must provide for public inspection and copying: (1) final opinions as well as orders made in the adjudication of cases; (2) statements of policy and interpretations not published in the Federal Register; (3) administrative staff manuals and instructions to staff that affect a member of the public; and (4) agency records which have been or the agency expects to be, the subject of repetitive FOIA requests. 5 U.S.C. sec. 552(a)(2). An agency must also publish in the Federal Register: the organizational structure of the agency and procedures for obtaining information under the FOIA; statements describing the functions of the agency and all formal and informal procedures; rules of procedure, descriptions of forms and statements describing all papers, reports and examinations; rules of general applicability and statements of general policy; and amendments, revisions and repeals of the foregoing. 5 U.S.C. sec. 552(a)(1). All other agency records can be sought by FOIA request; however, some records may be exempt from disclosure.

[29] Exemption 3 of the FOIA provides that an agency is not required to disclose matters that are:

(3) specifically exempted from disclosure by statute (other than section 552b of this title) provided that such statute (A) requires that the matters be withheld from the public in such a manner as to leave no discretion on the issue, or (B) establishes particular criteria for withholding or refers to particular types of matters to be withheld; . . .

5 U.S.C. 552(b)(3).

[30] Sec. 6110(m).

Pending in the U.S. District Court for the District of Columbia were three consolidated lawsuits asserting that, under prior law, APAs were subject to public disclosure under either section 6110 or the FOIA.[31] Prior to this litigation and since the inception of the APA program, the IRS held the position that APAs were confidential return information protected from disclosure by section 6103.[32] On January 11, 1999, the IRS conceded that APAs are "rulings" and therefore are "written determinations" for purposes of section 6110.[33] Although the court had not issued a ruling in the case, the IRS announced its plan to publicly release both existing and future APAs. The IRS then transmitted existing APAs to the respective taxpayers with proposed deletions. It received comments from some of the affected taxpayers. Where appropriate, foreign tax authorities also received copies of the relevant APAs for comment on the proposed deletions. No APAs were released to the public.

Some taxpayers asserted that the IRS erred in adopting the position under prior law that APAs are subject to section 6110 public disclosure. Several had sought to participate as amici in the lawsuit to block the release of APAs. They were concerned that release under section 6110 could expose them to expensive litigation to defend the deletion of the confidential information from their APAs. They were also concerned that the section 6110 procedures are insufficient to protect the confidentiality of their trade secrets and other financial and commercial information.

Reasons for Change

The APA program has been a successful mechanism for resolving transfer pricing issues, not only for future years, but, in some instances, for prior open years as well (rollbacks). It reduces protracted disputes and costly litigation between taxpayers and the government. The program involves not only taxpayers and the IRS, but also foreign taxing authorities.

As part of the program, the taxpayer voluntarily provides substantial, sensitive information to the IRS. The proprietary information necessary to support a claim of comparability may be among a company's most closely guarded trade secrets. Similarly, information regarding production costs and customer pricing may also be extremely sensitive information.

From the program's inception, the IRS had assured taxpayers and foreign governments that the information received or generated in the APA process would be protected as confidential return information. Such assurances were based on published IRS materials.

The APA process is based on taxpayers' cooperation and voluntary disclosure to the IRS of sensitive information. The Congress

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[31] *BNA v. IRS*, Nos. 96–376, 96–2820, and 96–1473 (D.D.C.). The Bureau of National Affairs, Inc. (BNA) publishes matters of interest for use by its subscribers. BNA contended that APAs were not return information as they are prospective in application. Thus, at the time they are entered into, they do not relate to "the determination of the existence, or possible existence, of liability or amount thereof . . ."

[32] The IRS contended that information received or generated as part of the APA process pertains to a taxpayer's liability and therefore was return information as defined in sec. 6103(b)(2)(A). Thus, the information was subject to section 6103's restrictions on the dissemination of returns and return information. Rev. Proc. 91–22, sec. 11, 1991–1 C.B. 526, 534 and Rev. Proc. 96–53, sec. 12, 1996–2 C.B. 375, 386.

[33] IR 1999–05.

believed that the continued confidentiality of this information was vital to the APA program. Otherwise, the Congress believed that some taxpayers may refuse to participate in this successful program, causing a decline in its usefulness.

The Congress must balance the need for confidentiality with the general public's need for practical tax guidance. Some members of the public have expressed concern that the APA program has led to the development of a body of "secret law," known only to a few members of the tax profession. In addition, some members of the public contend that taxpayers have received APAs permitting the use of transfer pricing methodologies not contemplated in the section 482 regulations. They also contend that APAs have provided interpretations of law not available to taxpayers that do not participate in the APA process. Such concerns could undermine the public's confidence in the IRS's ability to enforce fairly the transfer pricing rules. Thus, the provision requires the Department of the Treasury to prepare and publish an annual report regarding APAs, which will provide extensive information regarding the program, while clarifying that existing and future APAs and related background information continue to be confidential return information.

Explanation of Provision

The provision amends section 6103 to provide that APAs and related background information are confidential return information under section 6103. Related background information includes: the request for an APA, any material submitted in support of the request, and any communication (written or otherwise) prepared or received by the Secretary in connection with an APA, regardless of when such communication is prepared or received. Protection is not limited to agreements actually executed; it includes material received and generated in the APA process that does not result in an executed agreement.

Further, APAs and related background information are not "written determinations" as that term is defined in section 6110. Therefore, the public inspection requirements of section 6110 do not apply to APAs and related background information. A document's incorporation in a background file, however, is not intended to be grounds for not disclosing an otherwise disclosable document from a source other than a background file.

The provision statutorily requires that the Treasury Department prepare and publish an annual report on the status of APAs. The annual report is to contain the following information:

(1) Information about the structure, composition and, operation of the APA program office;

(2) A copy of each current model APA;

(3) Statistics regarding the amount of time to complete new and renewal APAs;

(4) The number of APA applications filed during such year;

(5) The number of APAs executed to date and for the year;

(6) The number of APA renewals issued to date and for the year;

(7) The number of pending APA requests;

(8) The number of pending APA renewals;

(9) The number of APAs executed and pending (including renewals and renewal requests) that are unilateral, bilateral and multilateral, respectively;

(10) The number of APAs revoked or canceled, and the number of withdrawals from the APA program, to date and for the year;

(11) The number of finalized new APAs and renewals by industry.[34]

In addition, the annual report is to contain general descriptions of:

(1) the nature of the relationships between the related organizations, trades, or businesses covered by APAs;

(2) the related organizations, trades, or businesses whose prices or results are tested to determine compliance with the transfer pricing methodology prescribed in the APA;

(3) the covered transactions and the functions performed and risks assumed by the related organizations, trades or businesses involved;

(4) methodologies used to evaluate tested parties and transactions and the circumstances leading to the use of those methodologies;

(5) critical assumptions;

(6) sources of comparables;

(7) comparable selection criteria and the rationale used in determining such criteria;

(8) the nature of adjustments to comparables and/or tested parties;

(9) the nature of any range agreed to, including information such as whether no range was used and why, whether an inter-quartile range was used, or whether there was a statistical narrowing of the comparables;

(10) adjustment mechanisms provided to rectify results that fall outside of the agreed upon APA range;

(11) the various term lengths for APAs, including rollback years, and the number of APAs with each such term length;

(12) the nature of documentation required; and

(13) approaches for sharing of currency or other risks.

In addition, the provision requires the Treasury Department to describe, in each annual report, its efforts to ensure compliance with existing APA agreements. The first report is to cover the period January 1, 1991, through the calendar year including the date of enactment. The Treasury Department cannot include any information in the report which would have been deleted under section 6110(c) if the report were a written determination as defined in section 6110. Additionally, the report cannot include any information which can be associated with or otherwise identify, directly or indirectly, a particular taxpayer. The Secretary is expected to obtain input from taxpayers to ensure proper protection of taxpayer information and, if necessary, utilize its regulatory authority to implement appropriate processes for obtaining this input. For pur-

[34] This information was previously released in IRS Publication 3218, "IRS Report on Application and Administration of I.R.C. Section 482."

poses of section 6103, the report requirement is treated as part of Title 26.

While the provision statutorily requires an annual report, it is not intended to discourage the Treasury Department from issuing other forms of guidance, such as regulations or revenue rulings, consistent with the confidentiality provisions of the Code.

Effective Date

The provision is effective on the date of enactment; accordingly, no APAs, regardless of whether executed before or after enactment, or related background file documents, can be released to the public after the date of enactment (December 17, 1999). It required the Treasury Department to publish the first annual report no later than March 30, 2000.[35]

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

B. Authority to Postpone Certain Tax-Related Deadlines by Reason of Year 2000 Failures (sec. 522 of the Tax Relief Extension Act)

Present and Prior Law

There were no specific provisions in prior law that permitted the Secretary of the Treasury to postpone tax-related deadlines by reason of Year 2000 (also known as "Y2K") failures. The Secretary is, however, permitted (under present and prior law) to postpone tax-related deadlines for other reasons. For example, the Secretary may specify that certain deadlines are postponed for a period of up to 90 days in the case of a taxpayer determined to be affected by a Presidentially declared disaster. The deadlines that may be postponed are the same as are postponed by reason of service in a combat zone. The provision does not apply for purposes of determining interest on any overpayment or underpayment.

The suspension of time applies to the following acts: (1) filing any return of income, estate, or gift tax (except employment and withholding taxes); (2) payment of any income, estate, or gift tax (except employment and withholding taxes); (3) filing a petition with the Tax Court for a redetermination of deficiency, or for review of a decision rendered by the Tax Court; (4) allowance of a credit or refund of any tax; (5) filing a claim for credit or refund of any tax; (6) bringing suit upon any such claim for credit or refund; (7) assessment of any tax; (8) giving or making any notice or demand for payment of any tax, or with respect to any liability to the United States in respect of any tax; (9) collection of the amount of any liability in respect of any tax; (10) bringing suit by the United States in respect of any liability in respect of any tax; and (11) any other act required or permitted under the internal revenue

[35] The first APA report was released on March 30, 2000. Internal Revenue Service, *Announcement and Report Concerning Advance Pricing Agreements,* 2000–16 IRB 1. A second APA report was released on March 30, 2001. Internal Revenue Service, Announcement 2001–32, *Announcement and Report Concerning Advance Pricing Agreements,* 2001–17 IRB 1.

laws specified in regulations prescribed under section 7508 by the Secretary.

Reasons for Change

Although the Congress anticipated that Y2K compliance would be high and that widespread failures would be unlikely, the Congress believed that it was appropriate to provide the Secretary with discretion to provide relief to affected taxpayers. The Congress believed that delegating this authority to the Secretary was appropriate, because any Y2K failures likely would have occurred while the Congress was not in session. Therefore, the Congress believed that it was appropriate to give the Secretary the authority to provide relief by postponing tax-related deadlines for those taxpayers who, despite have made good faith and reasonable efforts to avoid any such failures, were affected by an actual Y2K failure.

Explanation of Provision

The provision permits the Secretary to postpone, on a taxpayer-by-taxpayer basis, certain tax-related deadlines for a period of up to 90 days in the case of a taxpayer that the Secretary determines to have been affected by an actual Y2K related failure. In order to be eligible for relief, taxpayers must have made good faith, reasonable efforts to avoid any Y2K related failures. The relief is similar to that granted under the Presidentially declared disaster and combat zone provisions, except that employment and withholding taxes also are eligible for relief. The relief permits the abatement of both penalties and interest.

The relief may apply to the following acts: (1) filing of any return of income, estate, or gift tax, including employment and withholding taxes; (2) payment of any income, estate, or gift tax, including employment and withholding taxes; (3) filing a petition with the Tax Court; (4) allowance of a credit or refund of any tax; (5) filing a claim for credit or refund of any tax; (6) bringing suit upon any such claim for credit or refund; (7) assessment of any tax; (8) giving or making any notice or demand for payment of any tax, or with respect to any liability to the United States in respect of any tax; (9) collection of the amount of any liability in respect of any tax; (10) bringing suit by the United States in respect of any liability in respect of any tax; and (11) any other act required or permitted under the internal revenue laws specified or prescribed by the Secretary.

Effective Date

The provision is effective on the date of enactment (December 17, 1999).

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

C. Add Certain Vaccines Against Streptococcus Pneumoniae to the List of Taxable Vaccines (sec. 523 of the Tax Relief Extension Act and secs. 4131 and 4132 of the Code)

Prior Law

A manufacturer's excise tax is imposed at the rate of 75 cents per dose (sec. 4131) on the following vaccines recommended for routine administration to children: diphtheria, pertussis, tetanus, measles, mumps, rubella, polio, HIB (haemophilus influenza type B), hepatitis B, varicella (chicken pox), and rotavirus gastroenteritis. 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 ("Vaccine Trust Fund") to finance compensation awards under the Federal Vaccine Injury Compensation Program for individuals who suffer certain injuries following administration of the taxable vaccines. This program provides a substitute Federal, "no fault" insurance system for the State-law tort and private liability insurance systems otherwise applicable to vaccine manufacturers and physicians. 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

Streptococcus pneumoniae (often referred to as pneumococcus) is a bacteria that can cause bacterial meningitis, a brain or spinal cord infection, bacteremia, a bloodstream infection, and otitis media (ear infection). The Congress understood that each year in the United States, pneumococcal disease accounts for an estimated 3,000 cases of bacterial meningitis, 50,000 cases of bacteremia, 500,000 cases of pneumonia, and 7 million cases of otitis media among all age groups. The Congress understood that, while there currently was a vaccine effective in preventing pneumococcal diseases in adults, that vaccine, a polysaccaride vaccine, did not induce an adequate immune response in young children and therefore did not protect children against these diseases. The Congress further understood that the Food and Drug Administration's (the "FDA") was expected to approve a new, sugar protein conjugate vaccine against the disease and the Centers for Disease Control were expected to recommend this conjugate vaccine for routine inoculation of children. The Congress believed American children would benefit from wide use of this new vaccine. The Congress believed that, by including the new vaccine with those presently covered by the Vaccine Trust Fund, greater application of the vaccine will be promoted. The Congress, therefore, believed it is appropriate to add the conjugate vaccine against streptococcus pneumoniae to the list of taxable vaccines.

The Congress was aware that the Vaccine Trust Fund had a current cash-flow surplus in excess of $1.3 billion dollars.[36] However, the Congress thought was it prudent to gather more detailed information on the operation of the Vaccine Injury Compensation Program and likely future claims to assess the adequacy of the Vaccine Trust Fund. Therefore, the Congress found it appropriate to direct the Comptroller General of the United States to report on the operation and management of expenditures from the Vaccine Trust Fund and to advise the Congress on the adequacy of the Vaccine Trust Fund to meet future claims under the Federal Vaccine Injury Compensation Program.

Explanation of Provision

The provision adds any conjugate vaccine against streptococcus pneumoniae to the list of taxable vaccines. The provision also changes the effective date enacted in Public Law 105–277 and certain other conforming amendments to expenditure purposes to enable certain payments to be made from the Trust Fund.

In addition, the provision directs the General Accounting Office ("GAO") to report to the House Committee on Ways and Means and the Senate Committee on Finance on the operation and management of expenditures from the Vaccine Trust Fund and to advise the Committees on the adequacy of the Vaccine Trust Fund to meet future claims under the Federal Vaccine Injury Compensation Program.

Within its report, to the greatest extent possible, the Congress requested a thorough statistical report of the number of claims submitted annually, the number of claims settled annually, and the value of settlements. The Congress requested analysis of the statistical distribution of settlements, including the mean and median values of settlements, and the extent to which the value of settlements varies with an injury attributed to an identifiable vaccine. The Congress also requested analysis of the settlement process, including a statistical distribution of the amount of time required from the initial filing of a claim to a final resolution.

The Code provides that certain administrative expenses may be charged to the Vaccine Trust Fund. The Congress intended that the GAO report include an analysis of the overhead and administrative expenses charged to the Vaccine Trust Fund.

The GAO is directed to report its findings to the House Committee on Ways and Means and the Senate Committee on Finance by January 31, 2000.[37]

Effective Date

The provision is effective for vaccine sales beginning on the day after the date of enactment (December 17, 1999). No floor stocks tax is to be collected for amounts held for sale on that date. For sales on or before that date for which delivery is made after such date, the delivery date is deemed to be the sale date. The addition

[36] Joint Committee on Taxation, *Schedule of Present Federal Excise Taxes (as of January 1, 1999)* (JCS–2–99), March 29, 1999, p. 48.

[37] The GAO delivered its report on March 31, 2000. See, United States General Accounting Office, *Vaccine Injury Trust Fund Revenue Exceeds Current Need for Paying Claims,* GAO/HEHS–00-67, March 2000.

of conjugate streptococcus pneumoniae vaccines to the list of taxable vaccines is contingent upon the inclusion in this legislation of the modifications to Public Law 105–277.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $4 million in 2000, $7 million in 2001, $9 million in 2002, $10 million in 2003, $10 million in 2004, $10 million in 2005, $10 million in 2006, $10 million in 2007, $10 million in 2008, $11 million in 2009, and $11 million in 2010.

D. Delay in Effective Date of Requirement for Approved Diesel or Kerosene Terminal (sec. 524 of the Tax Relief Extension Act and sec. 4101 of the Code)

Present and Prior Law

Excise taxes are imposed on highway motor fuels, including gasoline, diesel fuel, and kerosene, to finance the Highway Trust Fund programs. Subject to limited exceptions, these taxes are imposed on all such fuels when they are removed from registered pipeline or barge terminal facilities, with any tax-exemptions being accomplished by means of refunds to consumers of the fuel.[38] One such exception allows removal of diesel fuel without payment of tax if the fuel is destined for a nontaxable use (e.g., use as heating oil) and is indelibly dyed.

Terminal facilities are not permitted to receive and store non-tax-paid motor fuels unless they are registered with the Internal Revenue Service. Under present law, a prerequisite to registration is that if the terminal offers for sale diesel fuel, it must offer both dyed and undyed diesel fuel. Similarly, if the terminal offers for sale kerosene, it must offer both dyed and undyed kerosene. This "dyed-fuel mandate" was enacted in 1997, to be effective on July 1, 1998. Subsequently, the effective date was delayed until July 1, 2000.

Reasons for Change

When the rules governing taxation of kerosene used as a highway motor fuel were enacted in 1997, the Congress was concerned that dyed kerosene (destined for nontaxable use) might not be available in markets where that fuel was commonly used (e.g., as heating oil). To ensure availability of untaxed kerosene for these uses, the Congress included a requirement that terminals offer both dyed and undyed kerosene and diesel fuel (if they offered the fuels for sale at all) as a condition of receiving untaxed fuels. Since that time, markets have provided dyed kerosene and diesel fuel for nontaxable uses in markets where there is a demand for such fuel even in the absence of a statutory mandate for such fuels. The Congress found that a further delay in this registration requirement was appropriate to allow a more complete evaluation before a decision is made on whether to repeal or retain the mandate.

[38] Tax is imposed before that point if the motor fuel is transferred (other than in bulk) from a refinery or if the fuel is sold to an unregistered party while still held in the refinery or bulk distribution system (e.g., in a pipeline or terminal facility).

Explanation of Provision

The provision delayed the effective date of the diesel fuel and kerosene-dyeing mandate through December 31, 2001. No other changes were made to the highway motor fuels excise tax rules.

Effective Date

The provision became effective on the date of enactment (December 17, 1999).

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

E. Production Flexibility Contract Payments (sec. 525 of the Tax Relief Extension Act)

Present and Prior Law

A taxpayer generally is required to include an item in income no later than the time of its actual or constructive receipt, unless such amount properly is accounted for in a different period under the taxpayer's method of accounting. If a taxpayer has an unrestricted right to demand the payment of an amount, the taxpayer is in constructive receipt of that amount whether or not the taxpayer makes the demand and actually receives the payment.

The Federal Agriculture Improvement and Reform Act of 1996 (the "FAIR Act") provides for production flexibility contracts between certain eligible owners and producers and the Secretary of Agriculture. These contracts generally cover crop years from 1996 through 2002. Annual payments are made under such contracts at specific times during the Federal government's fiscal year. Section 112(d)(2) of the FAIR Act provides that one-half of each annual payment is to be made on either December 15 or January 15 of the fiscal year, at the option of the recipient.[39] The remaining one-half of the annual payment must be made no later than September 30 of the fiscal year. The Emergency Farm Financial Relief Act of 1998 added section 112(d)(3) to the FAIR Act which provides that all payments for fiscal year 1999 are to be paid at such time or times during fiscal year 1999 as the recipient may specify. Thus, the one-half of the annual amount that would otherwise be required to be paid no later than September 30, 1999 can be specified for payment in calendar year 1998.

These options potentially would have resulted in the constructive receipt (and thus inclusion in income) of the payments to which they relate at the time they could have been exercised, whether or not they were in fact exercised. However, section 2012 of the Tax and Trade Relief Extension Act of 1998 provided that the time a production flexibility contract payment under the FAIR Act properly is includible in income is to be determined without regard to either option, effective for production flexibility contract payments

[39] This rule applies to fiscal years after 1996. For fiscal year 1996, this payment was to be made not later than 30 days after the production flexibility contract was entered into.

made under the FAIR Act in taxable years ending after December 31, 1995.

Reasons for Change [40]

The Congress did not believe that farmers should be required to accelerate the recognition of income on production flexibility contract payments solely because Congress creates an option for the accelerated receipt of such payments.

Explanation of Provision

The provision provides that any option to accelerate the receipt of any payment under a production flexibility contract which is payable under the FAIR Act, as in effect on the date of enactment of the provision, is to be disregarded in determining the taxable year in which such payment is properly included in gross income. Options to accelerate payments that are enacted in the future are covered by this rule, providing the payment to which they relate is mandated by the FAIR Act as in effect on the date of enactment of this Act.

The provision does not delay the inclusion of any amount in gross income beyond the taxable period in which the amount is received.

Effective Date

The provision is effective on the date of enactment (December 17, 1999).

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

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[40] The conference report to H.R. 1180 indicates that there was neither a House bill provision nor a Senate amendment provision. However, it refers to a provision included as section 711 of the conference agreement to H.R. 2488, the "Taxpayer Refund and Relief Act of 1999" (H. Rep. 106–289, Aug. 4, 1999), which was vetoed by President Clinton. The provision was reported by the House Ways and Means Committee as section 711 of H.R. 2488, the "Financial Freedom Act of 1999" (H. Rep. 106–238, July 16, 1999), from which these reasons for change are reproduced.

III. REVENUE OFFSETS

A. General Provisions

1. Modification of individual estimated tax safe harbor (sec. 531 of the Tax Relief Extension Act and sec. 6654 of the Code)

Present and Prior Law

An individual taxpayer generally is subject to an addition to tax for any underpayment of estimated tax. An individual generally does not have an underpayment of estimated tax if he or she makes timely estimated tax payments at least equal to: (1) 90 percent of the tax shown on the current year's return or (2) 100 percent of the prior year's tax. For taxpayers with a prior year's AGI above $150,000,[41] however, the rule that allows payment of 100 percent of prior year's tax is modified. Those taxpayers with AGI above $150,000 generally must make estimated payments based on either (1) 90 percent of the tax shown on the current year's return or (2) 110 percent of the prior year's tax.

For taxpayers with a prior year's AGI above $150,000, the prior year's tax safe harbor is modified for estimated tax payments made for taxable years through 2002. Under prior law, for such taxpayers making estimated tax payments based on prior year's tax, payments must be made based on 105 percent of prior year's tax for taxable years beginning in 1999, 106 percent of prior year's tax for taxable years beginning in 2000 and 2001, and 112 percent of prior year's tax for taxable years beginning in 2002.

Reasons for Change

The Congress believed that is appropriate to modify the applicability of the estimated tax safe harbor.

Explanation of Provision

The provision provides that taxpayers with prior year's AGI above $150,000 who make estimated tax payments based on prior year's tax must do so based on 108.6 percent of prior year's tax for estimated tax payments made for taxable year 2000. Taxpayers with prior year's AGI above $150,000 who make estimated tax payments based on prior year's tax must do so based on 110 percent of prior year's tax for estimated tax payments made for taxable year 2001. The Act does not change the modified safe harbor percentage for estimated tax payments made for any taxable years other than 2000 and 2001.

Effective Date

The provision is effective for estimated tax payments made for taxable years beginning after December 31, 1999, and before January 1, 2002.

[41] $75,000 for married taxpayers filing separately.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $1,560 million in 2000 and $840 million in 2001, and to reduce Federal fiscal year budget receipts by $2,400 million in 2002.

2. Clarify the tax treatment of income and losses on derivatives (sec. 532 of the Tax Relief Extension Act and sec. 1221 of the Code)

Present and Prior Law

Capital gain treatment applies to gain on the sale or exchange of a capital asset. Capital assets include property other than (1) stock in trade or other types of assets includible in inventory, (2) property used in a trade or business that is real property or property subject to depreciation, (3) accounts or notes receivable acquired in the ordinary course of a trade or business, (4) certain copyrights (or similar property), and (5) U.S. government publications. Gain or loss on such assets generally is treated as ordinary, rather than capital, gain or loss. Certain other Code sections also treat gains or losses as ordinary. For example, the gains or losses of securities dealers or certain electing commodities dealers or electing traders in securities or commodities that are subject to "mark-to-market" accounting are treated as ordinary (sec. 475).

Under case law in a number of Federal courts prior to 1988, business hedges generally were treated as giving rise to ordinary, rather than capital, gain or loss. In 1988, the U.S. Supreme Court rejected this interpretation in Arkansas Best v. Commissioner which, relying on the statutory definition of a capital asset described above, held that a loss realized on a sale of stock was capital even though the stock was purchased for a business, rather than an investment, purpose.[42]

Treasury regulations (which were finalized in 1994) under prior law require ordinary character treatment for most business hedges and provide timing rules requiring that gains or losses on hedging transactions be taken into account in a manner that matches the income or loss from the hedged item or items. The regulations apply to hedges that meet a standard of "risk reduction" with respect to ordinary property held (or to be held) or certain liabilities incurred (or to be incurred) by the taxpayer and that meet certain identification and other requirements (Treas. Reg. sec. 1.1221–2).

Reasons for Change

Absent an election by a commodities derivatives dealer to be treated the same as a dealer in securities under section 475, the character of the gains and losses with respect to commodities derivative financial instruments entered into by such a dealer may have been unclear under prior law. The Congress was concerned that this uncertainty (i.e., the potential for capital treatment of the commodities derivatives financial instruments) could inhibit commodities derivatives dealers from entering into transactions with re-

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[42] 485 U.S. 212 (1988).

spect to commodities derivative financial instruments that qualify as "hedging transactions" within the meaning of the Treasury regulations under section 1221. The Congress believes that commodities derivatives financial instruments are integrally related to the ordinary course of the trade or business of commodities derivatives dealers and, therefore, such assets should be treated as ordinary assets.

The Congress further believes that ordinary character treatment is proper for business hedges with respect to ordinary property. The Congress believes that the approach taken in the Treasury regulations under prior law with respect to the character of hedging transactions generally should be codified as an appropriate interpretation of prior law. Those Treasury regulations, however, modeled the definition of a hedging transaction after the prior-law definition contained in section 1256, which generally required that a hedging transaction "reduces" a taxpayer's risk. The Congress believes that a "risk management" standard better describes modern business hedging practices that should be accorded ordinary character treatment.[43]

In adopting a risk management standard, however, the Congress did not intend that speculative transactions or other transactions not entered into in the normal course of a taxpayer's trade or business should qualify for ordinary character treatment, and risk management should not be interpreted so broadly as to cover such transactions. In addition, to minimize whipsaw potential, the Congress believes that it is essential for hedging transactions to be properly identified by the taxpayer when the hedging transaction is entered into.

Finally, because hedging status under prior law and present law is dependent upon the ordinary character of the property being hedged, an issue arises with respect to hedges of certain supplies, sales of which could give rise to capital gain, but which are generally consumed in the ordinary course of a taxpayer's trade or business and that would give rise to ordinary deductions. For purposes of defining a hedging transaction, Treasury regulations treat such supplies as ordinary property.[44] The Congress believes that it was appropriate to confirm this treatment by specifying that such supplies are ordinary assets.

Explanation of Provision

The provision adds three categories to the list of assets the gain or loss on which is treated as ordinary (sec. 1221). The new categories are: (1) commodities derivative financial instruments en-

[43] The Congress believed that the Treasury regulations under prior law appropriately interpret "risk reduction" flexibly within the constraints of prior law. For example, the regulations recognize that certain transactions that economically convert an interest rate or price from a fixed rate or price to a floating rate or price may qualify as hedging transactions (Treas. Reg. sec. 1.1221–2(c)(1)(ii)(B)). Similarly, the regulations provide hedging treatment for certain written call options, hedges of aggregate risk, "dynamic hedges" (under which a taxpayer can more frequently manage or adjust its exposure to identified risk), partial hedges, "recycled" hedges (using a position entered into to hedge one asset or liability to hedge another asset or liability), and hedges of aggregate risk (Treas. Reg. sec. 1.1221–2(c)). The Congress believed that (depending on the facts) treatment of such transactions as hedging transactions was appropriate and that it also was appropriate to modernize the definition of a hedging transaction by providing risk management as the standard.

[44] Treas. Reg. sec. 1.1221–2(c)(5)(ii).

tered into by commodities derivatives dealers; (2) hedging transactions; and (3) supplies of a type regularly consumed by the taxpayer in the ordinary course of a taxpayer's trade or business.

For this purpose, a commodities derivatives dealer is any person that regularly offers to enter into, assume, offset, assign or terminate positions in commodities derivative financial instruments with customers in the ordinary course of a trade or business. A commodities derivative financial instrument means a contract or financial instrument with respect to commodities, the value or settlement price of which is calculated by reference to any combination of a fixed rate, price, or amount, or a variable rate, price, or amount, which is based on current, objectively determinable financial or economic information. This includes swaps, caps, floors, options, futures contracts, forward contracts, and similar financial instruments with respect to commodities. It does not include shares of stock in a corporation; a beneficial interest in a partnership or trust; a note, bond, debenture, or other evidence of indebtedness; or a contract to which section 1256 applies.

In defining a hedging transaction, the provision generally codifies the approach taken by the Treasury regulations under prior law, but modifies the rules. The "risk reduction" standard of the regulations is broadened to "risk management" with respect to ordinary property held (or to be held) or certain liabilities incurred (or to be incurred). In addition, the Treasury Secretary is granted authority to treat transactions that manage other risks as hedging transactions. As under the prior-law Treasury regulations, the transaction must be identified as a hedge of specified property. It is intended that this be the exclusive means through which the gains or losses with respect to a hedging transaction are treated as ordinary. Authority is provided for Treasury regulations that would address improperly identified or non-identified hedging transactions. The Treasury Secretary is also given authority to apply these rules to related parties.

Effective Date

The provision is effective for any instrument held, acquired or entered into, any transaction entered into, and supplies held or acquired on or after the date of enactment (December 17, 1999).

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by less than $500,000 for 2000, and $1 million in each of the years 2001 through 2010.

3. Expand reporting of cancellation of indebtedness income (sec. 533 of the Tax Relief Extension Act and sec. 6050P of the Code)

Present and Prior Law

Under section 61(a)(12), a taxpayer's gross income includes income from the discharge of indebtedness. Section 6050P requires "applicable entities" to file information returns with the Internal

Revenue Service (IRS) regarding any discharge of indebtedness of $600 or more.

The information return must set forth the name, address, and taxpayer identification number of the person whose debt was discharged, the amount of debt discharged, the date on which the debt was discharged, and any other information that the IRS requires to be provided. The information return must be filed in the manner and at the time specified by the IRS. The same information also must be provided to the person whose debt is discharged by January 31 of the year following the discharge.

Under prior law, "applicable entities" included only: (1) the Federal Deposit Insurance Corporation (FDIC), the Resolution Trust Corporation (RTC), the National Credit Union Administration, and any successor or subunit of any of them; (2) any financial institution (as described in sec. 581 (relating to banks) or sec. 591(a) (relating to savings institutions)); (3) any credit union; (4) any corporation that is a direct or indirect subsidiary of an entity described in (2) or (3) which, by virtue of being affiliated with such entity, is subject to supervision and examination by a Federal or State agency regulating such entities; and (5) an executive, judicial, or legislative agency (as defined in 31 U.S.C. sec. 3701(a)(4)).

Failures to file correct information returns with the IRS or to furnish statements to taxpayers with respect to these discharges of indebtedness are subject to the same general penalty that is imposed with respect to failures to provide other types of information returns. Accordingly, the penalty for failure to furnish statements to taxpayers is generally $50 per failure, subject to a maximum of $100,000 for any calendar year. These penalties are not applicable if the failure is due to reasonable cause and not to willful neglect.

Reasons for Change

The Congress believed that it was appropriate to treat discharges of indebtedness that are made by similar entities in a similar manner. Accordingly, the Congress believed that it was appropriate to extend the scope of this information reporting provision to include indebtedness discharged by any organization a significant trade or business of which is the lending of money (such as finance companies and credit card companies whether or not affiliated with financial institutions).

Explanation of Provision

The provision requires information reporting on indebtedness discharged by any organization a significant trade or business of which is the lending of money (such as finance companies and credit card companies whether or not affiliated with financial institutions).

Effective Date

The provision is effective with respect to discharges of indebtedness after December 31, 1999.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $7 million in each of the years 2001 through 2010.

4. Limitation on conversion of character of income from constructive ownership transactions (sec. 534 of the Tax Relief Extension Act and new sec. 1260 of the Code)

Present and Prior Law

The maximum individual income tax rate on ordinary income and short-term capital gain is 39.6 percent, while the maximum individual income tax rate on long-term capital gain generally is 20 percent. Long-term capital gain means gain from the sale or exchange of a capital asset held more than one year. For this purpose, gain from the termination of a right with respect to property which would be a capital asset in the hands of the taxpayer is treated as capital gain.[45]

A pass-thru entity (such as a partnership) generally is not subject to Federal income tax. Rather, each owner includes its share of a pass-thru entity's income, gain, loss, deduction or credit in its taxable income. Generally, the character of the item is determined at the entity level and flows through to the owners. Thus, for example, the treatment of an item of income by a partnership as ordinary income, short-term capital gain, or long-term capital gain retains its character when reported by each of the partners.

Investors could enter into forward contracts, notional principal contracts, and other similar arrangements with respect to property that provided the investor with the same or similar economic benefits as owning the property directly but with potentially different tax consequences (as to the character and timing of any gain).

Reasons for Change

The Congress was concerned with the use of derivative contracts by taxpayers in arrangements that are primarily designed to convert what otherwise would be ordinary income and short-term capital gain into long-term capital gain. Of particular concern were derivative contracts with respect to partnerships and other pass-thru entities. The use of such derivative contracts could result in the taxpayer being taxed in a more favorable manner than had the taxpayer actually acquired an ownership interest in the entity. The rules designed to prevent the conversion of ordinary income into capital gain (sec. 1258) only apply to transactions where the taxpayer's expected return is attributable solely to the time value of the taxpayer's net investment.

One example of a conversion transaction involving a derivative contract is when a taxpayer enters into an arrangement with a securities dealer[46] whereby the dealer agrees to pay the taxpayer any appreciation with respect to a notional investment in a hedge fund. In return, the taxpayer agrees to pay the securities dealer

[45] Section 1234A, as amended by the Taxpayer Relief Act of 1997.

[46] Assuming the securities dealer purchases the financial asset, the dealer would mark both the financial asset and the contractual arrangement to market under Code sec. 475, and the economic (and tax) consequences of the two positions would offset each other.

any depreciation in the value of the notional investment. The arrangement lasts for more than one year. The taxpayer is substantially in the same economic position as if he or she owned the interest in the hedge fund. However, the taxpayer may treat any appreciation resulting from the contractual arrangement as long-term capital gain. Moreover, any tax attributable to such gain is deferred until the arrangement is terminated.

Explanation of Provision

The provision limits the amount of long-term capital gain a taxpayer can recognize from certain derivative contracts (”constructive ownership transactions”) with respect to certain financial assets. The amount of long-term capital gain is limited to the amount of such gain the taxpayer would have recognized if the taxpayer held the financial asset directly during the term of the derivative contract. Any gain in excess of this amount is treated as ordinary income. An interest charge is imposed on the amount of gain that is treated as ordinary income. The provision does not alter the tax treatment of the long-term capital gain that is not treated as ordinary income.

A taxpayer is treated as having entered into a constructive ownership transaction if the taxpayer (1) holds a long position under a notional principal contract with respect to the financial asset, (2) enters into a forward contract to acquire the financial asset, (3) is the holder of a call option, and the grantor of a put option, with respect to a financial asset, and the options have substantially equal strike prices and substantially contemporaneous maturity dates, or (4) to the extent provided in regulations, enters into one or more transactions, or acquires one or more other positions, that have substantially the same effect as any of the transactions described. Treasury regulations, when issued, are expected to provide specific standards for determining when other types of financial transactions, like those specified in the provision, have substantially the same effect of replicating the economic benefits of direct ownership of a financial asset without a significant change in the risk-reward profile with respect to the underlying transaction.[47]

A “financial asset” is defined as (1) any equity interest in a pass-thru entity, and (2) to the extent provided in regulations, any debt instrument and any stock in a corporation that is not a pass-thru entity. A “pass-thru entity” refers to (1) a regulated investment company, (2) a real estate investment trust, (3) a real estate mortgage investment conduit, (4) an S corporation, (5) a partnership, (6) a trust, (7) a common trust fund, (8) a passive foreign investment company,[48] (9) a foreign personal holding company, and (10) a foreign investment company.

The amount of recharacterized gain is calculated as the excess of the amount of long-term capital gain the taxpayer would have had absent this provision over the “net underlying long-term capital gain” attributable to the financial asset. The net underlying long-term capital gain is the amount of net capital gain the taxpayer

[47] It is not expected that leverage in a constructive ownership transaction would change the risk-reward profile with respect to the underlying transaction.

[48] For this purpose, a passive foreign investment company includes an investment company that is also a controlled foreign corporation.

would have realized if it had acquired the financial asset for its fair market value on the date the constructive ownership transaction was opened and sold the financial asset on the date the transaction was closed (only taking into account gains and losses that would have resulted from a deemed ownership of the financial asset).[49] The long-term capital gains rate on the net underlying long-term capital gain is determined by reference to the individual capital gains rates in section 1(h).

Example 1: On January 1, 2000, Taxpayer enters into a three-year notional principal contract (a constructive ownership transaction) with a securities dealer whereby, on the settlement date, the dealer agrees to pay Taxpayer the amount of any increase in the notional value of an interest in an investment partnership (the financial asset). After three years, the value of the notional principal contract increased by $200,000, of which $150,000 is attributable to ordinary income and net short-term capital gain ($50,000 is attributable to net long-term capital gains). The amount of the net underlying long-term capital gains is $50,000, and the amount of gain that is recharacterized as ordinary income is $150,000 (the excess of $200,000 of long-term gain over the $50,000 of net underlying long-term capital gain).

An interest charge is imposed on the underpayment of tax for each year that the constructive ownership transaction was open. The interest charge is the amount of interest that would be imposed under section 6601 had the recharacterized gain been included in the taxpayer's gross income during the term of the constructive ownership transaction. The recharacterized gain is treated as having accrued such that the gain in each successive year is equal to the gain in the prior year increased by a constant growth rate[50] during the term of the constructive ownership transaction.

Example 2: Same facts as in example 1, and assume the applicable Federal rate on December 31, 2002, is six percent. For purposes of calculating the interest charge, Taxpayer must allocate the $150,000 of recharacterized ordinary income to the three year-term of the constructive ownership transaction as follows: $47,116.47 is allocated to year 2000, $49,943.46 is allocated to year 2001, and $52,940.07 is allocated to year 2002.

A taxpayer is treated as holding a long position under a notional principal contract with respect to a financial asset if the person (1) has the right to be paid (or receive credit for) all or substantially all of the investment yield (including appreciation) on the financial asset for a specified period, and (2) is obligated to reimburse (or provide credit) for all or substantially all of any decline in the value of the financial asset. A forward contract is a contract to acquire in the future (or provide or receive credit for the future value of) any financial asset.

If the constructive ownership transaction is closed by reason of taking delivery of the underlying financial asset, the taxpayer is treated as having sold the contract, option, or other position that

[49] A taxpayer must establish the amount of the net underlying long-term capital gain with clear and convincing evidence; otherwise, the amount is deemed to be zero. To the extent that the economic positions of the taxpayer and the counterparty do not equally offset each other, the amount of the net underlying long-term capital gain may be difficult to establish.

[50] The accrual rate is the applicable Federal rate on the day the transaction closed.

is part of the transaction for its fair market value on the closing date. However, the amount of gain that is recognized as a result of having taken delivery is limited to the amount of gain that is treated as ordinary income by reason of this provision (with appropriate basis adjustments for such gain).

The provision does not apply to any constructive ownership transaction if all of the positions that are part of the transaction are marked to market under the Code or regulations. The Treasury Department is authorized to prescribe regulations as necessary to carry out the purposes of the provision, including to (1) permit taxpayers to mark to market constructive ownership transactions in lieu of the provision, and (2) exclude certain forward contracts that do not convey substantially all of the economic return with respect to a financial asset.

No inference is intended as to the proper treatment of a constructive ownership transaction entered into prior to the effective date of this provision.

Effective Date

The provision applies to transactions entered into on or after July 12, 1999. For this purpose, it is expected that a contract, option or any other arrangement that is entered into or exercised on or after July 12, 1999, which extends or otherwise modifies the terms of a transaction entered into prior to such date will be treated as a transaction entered into on or after July 12, 1999, unless a party to the transaction other than the taxpayer has, as of July 12, 1999, the exclusive right to extend the terms of the transaction, and the length of such extension does not exceed the first business day following a period of five years from the original termination date under the transaction.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $15 million in 2000, $45 million in 2001, $47 million in 2002, $49 million in 2003, $51 million in 2004, $54 million in 2005, $58 million in 2006, $62 million in 2007, $66 million in 2008, $70 million in 2009, and $74 million in 2010.

5. Treatment of excess pension assets used for retiree health benefits (sec. 535 of the Tax Relief Extension Act, sec. 420 of the Code, and secs. 101, 403, and 408 of ERISA)

Present and Prior Law

Defined benefit pension plan assets generally may not revert to an employer prior to the termination of the plan and the satisfaction of all plan liabilities. A reversion prior to plan termination may constitute a prohibited transaction and may result in disqualification of the plan. Certain limitations and procedural requirements apply to a reversion upon plan termination. 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, which may be as high as 50 percent of the reversion, varies depending upon whether or not the employer maintains a re-

placement plan or makes certain benefit increases. 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 section 401(h) account that is a part of such plan. A qualified transfer of excess assets of a defined benefit pension plan (other than a multiemployer plan) into a section 401(h) account that is a part of such plan does not result in plan disqualification and is not treated as a reversion to the employer or a prohibited transaction. Therefore, the transferred assets are not includible in the gross income of the employer and are not subject to the excise tax on reversions.

Qualified transfers are subject to amount and frequency limitations, use requirements, deduction limitations, and vesting requirements. Under prior law, qualified transfers were also subject to minimum benefit requirements.

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 more than one qualified transfer with respect to any plan may occur in any taxable year.

The transferred assets (and any income thereon) must be used to pay qualified current retiree health liabilities (either directly or through reimbursement) for the taxable year of the transfer. Transferred amounts generally must benefit all pension plan participants, other than key employees, who are entitled upon retirement to receive retiree medical benefits through the section 401(h) account. Retiree health benefits of key employees may not be paid (directly or indirectly) 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 at the end of the taxable year 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.

No deduction is allowed for (1) a qualified transfer of excess pension assets into a section 401(h) account, (2) the payment of qualified current retiree health liabilities out of transferred assets (and any income thereon) or (3) a return of amounts not used to pay qualified current retiree health liabilities to the general assets of the pension plan.

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.

Under prior law, the minimum benefit requirement required each group health plan under which applicable health benefits were provided to provide substantially the same level of applicable health benefits for the taxable year of the transfer and the following 4 taxable years. The level of benefits that were required to be maintained was based on benefits provided in the year immediately preceding the taxable year of the transfer. Applicable health benefits are health benefits or coverage that are provided to (1) retirees who, immediately before the transfer, are entitled to receive such benefits upon retirement and who are entitled to pension ben-

efits under the plan and (2) the spouses and dependents of such retirees.

Under prior law, the provision permitting a qualified transfer of excess pension assets to pay qualified current retiree health liabilities expired for taxable years beginning after December 31, 2000.[51]

Reasons for Change

The Congress believed that it is appropriate to provide a temporary extension of the rule permitting an employer to make a qualified transfer of excess pension assets to a section 401(h) account for retiree health benefits as long as the security of employees' pension benefits is not threatened by the transfer. In light of the increasing cost of retiree health benefits, the Congress also believed that it is appropriate to replace the minimum benefit requirement applicable to qualified transfers under prior law with a minimum cost requirement.

Explanation of Provision

The Tax Relief Extension Act extends the provision permitting qualified transfers of excess defined benefit pension plan assets to provide retiree health benefits under a section 401(h) account through December 31, 2005.[52] In addition, the Tax Relief Extension Act replaces the prior-law minimum benefit requirement with the minimum cost requirement that applied to qualified transfers before December 9, 1994, to section 401(h) accounts. Therefore, each group health plan or arrangement under which applicable health benefits are provided is required to provide a minimum dollar level of retiree health expenditures for the taxable year of the transfer and the following 4 taxable years. The minimum dollar level is the higher of the applicable employer costs for each of the 2 taxable years immediately preceding the taxable year of the transfer. The applicable employer cost for a taxable year is determined by dividing the employer's qualified current retiree health liabilities by the number of individuals to whom coverage for applicable health benefits was provided during the taxable year. The modification of the minimum benefit requirement is effective with respect to transfers after the date of enactment. The Secretary of the Treasury is directed to prescribe such regulations as may be necessary to prevent an employer who significantly reduces retiree health coverage during the cost maintenance period from being treated as satisfying the minimum cost requirement. In addition, the Tax Relief Extension Act contains a transition rule regarding the minimum cost requirement. Under this rule, an employer must satisfy the minimum benefit requirement with respect to a qualified transfer that occurs after the date of enactment during the portion of the cost mainte-

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[51] Title I of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), provides that plan participants, the Secretaries of Treasury and the Department of Labor, the plan administrator, and each employee organization representing plan participants must be notified 60 days before a qualified transfer of excess assets to a retiree health benefits account occurs (ERISA sec. 103(e)). ERISA also provides that a qualified transfer is not a prohibited transaction under ERISA (ERISA sec. 408(b)(13)) or a prohibited reversion of assets to the employer (ERISA sec. 403(c)(1)). For purposes of these provisions, a qualified transfer was generally defined under prior law as a transfer pursuant to section 420 of the Internal Revenue Code, as in effect on January 1, 1995.

[52] The Tax Relief Extension Act modifies the corresponding provisions of ERISA.

nance period of such transfer that overlaps the benefit maintenance period of a qualified transfer that occurs on or before the date of enactment. For example, suppose an employer (with a calendar year taxable year) made a qualified transfer in 1998. The minimum benefit requirement must be satisfied for calendar years 1998, 1999, 2000, 2001, and 2002. Suppose the employer also makes a qualified transfer in 2000. Then, the employer is required to satisfy the minimum benefit requirement in 2000, 2001, and 2002, and is required to satisfy the minimum cost requirement in 2003 and 2004.

Effective Date

The provision is effective with respect to qualified transfers of excess defined benefit pension plan assets to section 401(h) accounts after December 31, 2000, and before January 1, 2006. The modification of the minimum benefit requirement is effective with respect to transfers after the date of enactment. In addition, the provision contains a transition rule regarding the minimum cost requirement. Under this rule, an employer must satisfy the minimum benefit requirement with respect to a qualified transfer that occurs after the date of enactment during the portion of the cost maintenance period of such transfer that overlaps the benefit maintenance period of a qualified transfer that occurs on or before the date of enactment. For example, suppose an employer (with a calendar year taxable year) made a qualified transfer in 1998. The minimum benefit requirement must be satisfied for calendar years 1998, 1999, 2000, 2001, and 2002. Suppose the employer also makes a qualified transfer in 2000. Then, the employer is required to satisfy the minimum benefit requirement in 2000, 2001, and 2002, and is required to satisfy the minimum cost requirement in 2003 and 2004.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $19 million in 2001, $38 million in 2002, $39 million in 2003, $40 million in 2004, $43 million in 2005, and $23 million in 2006.

6. Modification of installment method and repeal of installment method for accrual method taxpayers (sec. 536 of the Tax Relief Extension Act and sections 453 and 453A of the Code)

Present and Prior Law

An accrual method taxpayer is generally required to recognize income when all the events have occurred that fix the right to the receipt of the income and the amount of the income can be determined with reasonable accuracy. The installment method of accounting provides an exception to this general principle of income recognition by allowing a taxpayer to defer the recognition of income from the disposition of certain property until payment is received. Sales to customers in the ordinary course of business are not eligible for the installment method, except for sales of property

that is used or produced in the trade or business of farming and sales of timeshares and residential lots if an election to pay interest under section 453(l)(2)(B) is made.

A pledge rule provides that if an installment obligation is pledged as security for any indebtedness, the net proceeds[53] of such indebtedness are treated as a payment on the obligation, triggering the recognition of income. Actual payments received on the installment obligation subsequent to the receipt of the loan proceeds are not taken into account until such subsequent payments exceed the loan proceeds that were treated as payments. The pledge rule does not apply to sales of property used or produced in the trade or business of farming, to sales of timeshares and residential lots where the taxpayer elects to pay interest under section 453(l)(2)(B), or to dispositions where the sales price does not exceed $150,000.

An additional rule requires the payment of interest on the deferred tax that is attributable to most large installment sales.

Reasons for Change

The Congress believed that the installment method is inconsistent with the use of an accrual method of accounting and should not be allowed in situations where the disposition of property would otherwise be reported using the accrual method. The Congress was concerned that the continued use of the installment method in such situations would allow a deferral of gain that is inconsistent with the requirement of the accrual method that income be reported in the period it is earned, rather than the period it is received.

The Congress also believed that the installment method, where its use is appropriate, should not serve to defer the recognition of gain beyond the time when funds are received. Accordingly, the Congress believed that proceeds of a loan should be treated in the same manner as a payment on an installment obligation if the loan is dependent on the existence of the installment obligation, such as where the loan is secured by the installment obligation or can be satisfied by the delivery of the installment obligation.

Explanation of Provision

Repeal of the installment method for accrual method taxpayers[54]

The Act generally prohibits the use of the installment method of accounting for dispositions of property that would otherwise be reported for Federal income tax purposes using an accrual method of accounting. The provision does not change present law regarding the availability of the installment method for dispositions of property used or produced in the trade or business of farming. The provision also does not change present law regarding the availability

[53] The net proceeds equal the gross loan proceeds less the direct expenses of obtaining the loan.

[54] The Installment Tax Correction Act of 2000 (P.L. 106–573) subsequently repealed the prohibition of the use of the installment method for accrual method taxpayers as if it had not been enacted. The Installment Tax Correction Act of 2000 left unchanged the modifications made by this provision to the pledge rule.

of the installment method for dispositions of timeshares or residential lots if the taxpayer elects to pay interest under section 453(l).

The provision does not change the ability of a cash method taxpayer to use the installment method. For example, a cash method individual owns all of the stock of a closely held accrual method corporation. This individual sells his stock for cash, a ten-year note, and a percentage of the gross revenues of the company for next ten years. The provision does not change the ability of this individual to use the installment method in reporting the gain on the sale of the stock.

Modifications to the pledge rule

The Act modifies the pledge rule to provide that entering into any arrangement that gives the taxpayer the right to satisfy an obligation with an installment note will be treated in the same manner as the direct pledge of the installment note. For example, a taxpayer disposes of property for an installment note. The disposition is properly reported using the installment method. The taxpayer only recognizes gain as it receives the deferred payment. However, were the taxpayer to pledge the installment note as security for a loan, the taxpayer would be required to treat the proceeds of such loan as a payment on the installment note, and recognize the appropriate amount of gain. Under the provision, the taxpayer would also be required to treat the proceeds of a loan as payment on the installment note to the extent the taxpayer had the right to "put" or repay the loan by transferring the installment note to the taxpayer's creditor. Other arrangements that have a similar effect would be treated in the same manner.

The modification of the pledge rule applies only to installment sales where the pledge rule of present law applies. Accordingly, the provision does not apply to (1) installment method sales made by a dealer in timeshares and residential lots where the taxpayer elects to pay interest under section 453(l)(2)(B), (2) sales of property used or produced in the trade or business of farming, or (3) dispositions where the sales price does not exceed $150,000, since such sales are not subject to the pledge rule under present law.

Effective Date

The provision is effective for sales or other dispositions entered into on or after the date of enactment (December 17, 1999).

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $489 million in 2000, $694 million in 2001, $416 million in 2002, $257 million in 2003, $72 million in 2004, $10 million in 2005, $21 million in 2006, $35 million in 2007, $48 million in 2008, $62 million in 2009, and $78 million in 2010.

7. Denial of charitable contribution deduction for transfers associated with split-dollar insurance arrangements (sec. 537 of the Tax Relief Extension Act and new sec. 501(c)(28) of the Code)

Present and Prior Law

Under present and prior law, in computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct charitable contributions paid during the taxable year. The amount of the deduction allowable for a taxable year with respect to any charitable contribution depends on the type of property contributed, the type of organization to which the property is contributed, and the income of the taxpayer (secs. 170(b) and 170(e)). A charitable contribution is defined to mean a contribution or gift to or for the use of a charitable organization or certain other entities (sec. 170(c)). The term "contribution or gift" is not defined by statute, but generally is interpreted to mean a voluntary transfer of money or other property without receipt of adequate consideration and with donative intent. If a taxpayer receives or expects to receive a quid pro quo in exchange for a transfer to charity, the taxpayer may be able to deduct the excess of the amount transferred over the fair market value of any benefit received in return, provided the excess payment is made with the intention of making a gift.[55]

In general, no charitable contribution deduction is allowed for a transfer to charity of less than the taxpayer's entire interest (i.e., a partial interest) in any property (sec. 170(f)(3)). In addition, no deduction is allowed for any contribution of $250 or more unless the taxpayer obtains a contemporaneous written acknowledgment from the donee organization that includes a description and good faith estimate of the value of any goods or services provided by the donee organization to the taxpayer in consideration, whole or part, for the taxpayer's contribution (sec. 170(f)(8)).

Reasons for Change

The Congress was concerned about an abusive scheme[56] referred to as charitable split-dollar life insurance, and the provision is designed to stop the spread of this scheme. Under this scheme, taxpayers typically transfer money to a charity, which the charity then uses to pay premiums for cash value life insurance on the transferor or another person. The beneficiaries under the life insurance contract typically include members of the transferor's family (either directly or through a family trust or family partnership). Having passed the money through a charity, the transferor claims a charitable contribution deduction for money that is actually being used to benefit the transferor and his or her family. If the transferor or the transferor's family paid the premium directly, the payment would not be deductible. Although the charity eventually may

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[55] *United States v. American Bar Endowment*, 477 U.S. 105 (1986). Treas. Reg. sec. 1.170A–1(h).

[56] "A Popular Tax Shelter for 'Angry Affluent' Prompts Ire of Others," *Wall Street Journal,* Jan. 22, 1999, p. A1; "U.S. Treasury Officials Investigating Charitable Split-Dollar Insurance Plan," *Wall Street Journal,* Jan. 29, 1999, p. B5; "Brilliant Deduction?," *The Chronicle of Philanthropy,* Aug. 13, 1998, p. 24; "Charitable Reverse Split-Dollar: Bonanza or Booby Trap," *Journal of Gift Planning,* 2nd quarter 1998.

get some of the benefit under the life insurance contract, it does not have unfettered use of the transferred funds.

The Congress was concerned that this type of transaction represents an abuse of the charitable contribution deduction. The Congress was also concerned that the charity often gets relatively little benefit from this type of scheme, and serves merely as a conduit or accommodation party, which the Congress did not view as appropriate for an organization with tax-exempt status. In substance, the charity receives a transfer of a partial interest in an insurance policy, for which no charitable contribution deduction is allowed. While there was no basis under prior law for allowing a charitable contribution deduction in these circumstances, the Congress intended that the provision stop the marketing of these transactions immediately.

Therefore, the provision clarifies prior law by specifically denying a charitable contribution deduction for a transfer to a charity if the charity directly or indirectly pays or paid any premium on a life insurance, annuity or endowment contract in connection with the transfer, and any direct or indirect beneficiary under the contract is the transferor, any member of the transferor's family, or any other noncharitable person chosen by the transferor. In addition, the provision clarifies prior law by specifically denying the deduction for a charitable contribution if, in connection with a transfer to the charity, there is an understanding or expectation that any person will directly or indirectly pay any premium on any such contract.

The provision provides that certain persons are not treated as indirect beneficiaries, in certain cases in which a charitable organization purchases an annuity contract to fund an obligation to pay a charitable gift annuity. The provision also provides that a person is not treated as an indirect beneficiary solely by reason of being a noncharitable recipient of an annuity or unitrust amount paid by a charitable remainder trust that holds a life insurance, annuity or endowment contract. The rationale for these rules is that the amount of the charitable contribution deduction is limited under prior and present law to the value of the charitable organization's interest. Congress had previously enacted rules designed to prevent a charitable contribution deduction for the value of any personal benefit to the donor in these circumstances, and the Congress expected that the personal benefit to the donor be appropriately valued.

Further, the provision imposes an excise tax on the charity, equal to the amount of the premiums paid by the charity. Finally, the provision requires a charity to report annually to the Internal Revenue Service the amount of premiums subject to this excise tax and information about the beneficiaries under the contract.

Explanation of Provision

Deduction denial

The provision[57] restates prior law to provide that no charitable contribution deduction is allowed for purposes of Federal tax, for a transfer to or for the use of an organization described in section 170(c) of the Internal Revenue Code, if in connection with the transfer (1) the organization directly or indirectly pays, or has previously paid, any premium on any "personal benefit contract" with respect to the transferor, or (2) there is an understanding or expectation that any person will directly or indirectly pay any premium on any "personal benefit contract" with respect to the transferor. It is intended that an organization be considered as indirectly paying premiums if, for example, another person pays premiums on its behalf.

A personal benefit contract with respect to the transferor is any life insurance, annuity, or endowment contract, if any direct or indirect beneficiary under the contract is the transferor, any member of the transferor's family, or any other person (other than a section 170(c) organization) designated by the transferor. For example, such a beneficiary would include a trust having a direct or indirect beneficiary who is the transferor or any member of the transferor's family, and would include an entity that is controlled by the transferor or any member of the transferor's family. It is intended that a beneficiary under the contract include any beneficiary under any side agreement relating to the contract. If a transferor contributes a life insurance contract to a section 170(c) organization and designates one or more section 170(c) organizations as the sole beneficiaries under the contract, generally, it is not intended that the deduction denial rule under the provision apply. If, however, there is an outstanding loan under the contract upon the transfer of the contract, then the transferor is considered as a beneficiary. The fact that a contract also has other direct or indirect beneficiaries (persons who are not the transferor or a family member, or designated by the transferor) does not prevent it from being a personal benefit contract. The provision is not intended to affect situations in which an organization pays premiums under a legitimate fringe benefit plan for employees.

It is intended that a person be considered as an indirect beneficiary under a contract if, for example, the person receives or will receive any economic benefit as a result of amounts paid under or with respect to the contract. For this purpose, as described below, an indirect beneficiary is not intended to include a person that benefits exclusively under a bona fide charitable gift annuity (within the meaning of sec. 501(m)).

In the case of a charitable gift annuity, if the charitable organization purchases an annuity contract issued by an insurance company to fund its obligation to pay the charitable gift annuity, a person receiving payments under the charitable gift annuity is not treated as an indirect beneficiary, provided certain requirements are met. The requirements are that (1) the charitable organization

[57] The provision is similar to H.R. 630, introduced by Mr. Archer and Mr. Rangel (106th Cong., 1st Sess.).

possess all of the incidents of ownership (within the meaning of Treas. Reg. sec. 20.2042–1(c)) under the annuity contract purchased by the charitable organization; (2) the charitable organization be entitled to all the payments under the contract; and (3) the timing and amount of payments under the contract be substantially the same as the timing and amount of payments to each person under the organization's obligation under the charitable gift annuity (as in effect at the time of the transfer to the charitable organization).

Under the provision, an individual's family consists of the individual's grandparents, the grandparents of the individual's spouse, the lineal descendants of such grandparents, and any spouse of such a lineal descendant.

In the case of a charitable gift annuity obligation that is issued under the laws of a State that requires, in order for the charitable gift annuity to be exempt from insurance regulation by that State, that each beneficiary under the charitable gift annuity be named as a beneficiary under an annuity contract issued by an insurance company authorized to transact business in that State, then the foregoing requirements (1) and (2) are treated as if they are met, provided that certain additional requirements are met. The additional requirements are that the State law requirement was in effect on February 8, 1999, each beneficiary under the charitable gift annuity is a bona fide resident of the State at the time the charitable gift annuity was issued, the only persons entitled to payments under the annuity contract issued by the insurance company are persons entitled to payments under the charitable gift annuity when it was issued, and (as required by clause (iii) of subparagraph (D) of the provision) the timing and amount of payments under the annuity contract to each person are substantially the same as the timing and amount of payments to the person under the charitable organization's obligation under the charitable gift annuity (as in effect at the time of the transfer to the charitable organization).

In the case of a charitable remainder annuity trust or charitable remainder unitrust (as defined in section 664(d)) that holds a life insurance, endowment or annuity contract issued by an insurance company, a person is not treated as an indirect beneficiary under the contract held by the trust, solely by reason of being a recipient of an annuity or unitrust amount paid by the trust, provided that the trust possesses all of the incidents of ownership under the contract and is entitled to all the payments under such contract. No inference is intended as to the applicability of other provisions of the Code with respect to the acquisition by the trust of a life insurance, endowment or annuity contract, or the appropriateness of such an investment by a charitable remainder trust.

Nothing in the provision is intended to suggest that a life insurance, endowment, or annuity contract would be a personal benefit contract, solely because an individual who is a recipient of an annuity or unitrust amount paid by a charitable remainder annuity trust or charitable remainder unitrust uses such a payment to purchase a life insurance, endowment or annuity contract, and a beneficiary under the contract is the recipient, a member of his or her family, or another person he or she designates.

Excise tax

The provision imposes on any organization described in section 170(c) of the Code an excise tax, equal to the amount of the premiums paid by the organization on any life insurance, annuity, or endowment contract, if the premiums are paid in connection with a transfer for which a deduction is not allowable under the deduction denial rule of the provision (without regard to when the transfer to the charitable organization was made). The excise tax does not apply if all of the direct and indirect beneficiaries under the contract (including any related side agreement) are organizations described in section 170(c). Under the provision, payments are treated as made by the organization, if they are made by any other person pursuant to an understanding or expectation of payment. The excise tax is to be applied taking into account rules ordinarily applicable to excise taxes in chapter 41 or 42 of the Code (e.g., statute of limitation rules).

Reporting

The provision requires that the charitable organization annually report the amount of premiums that is paid during the year and that is subject to the excise tax imposed under the provision, and the name and taxpayer identification number of each beneficiary under the life insurance, annuity or endowment contract to which the premiums relate, as well as other information required by the Secretary of the Treasury. For this purpose, it is intended that a beneficiary include any beneficiary under any side agreement to which the section 170(c) organization is a party (or of which it is otherwise aware). Penalties applicable to returns required under Code section 6033 apply to returns under this reporting requirement. Returns required under this provision are to be furnished at such time and in such manner as the Secretary shall by forms or regulations require.

Regulations

The provision provides for the promulgation of regulations necessary or appropriate to carry out the purposes of the provisions, including regulations to prevent the avoidance of the purposes of the provision. For example, it is intended that regulations prevent avoidance of the purposes of the provision by inappropriate or improper reliance on the limited exceptions provided for certain beneficiaries under *bona fide* charitable gift annuities and for certain noncharitable recipients of an annuity or unitrust amount paid by a charitable remainder trust.

Effective Date

The deduction denial provision applies to transfers after February 8, 1999 (as provided in H.R. 630). The excise tax provision applies to premiums paid after the date of enactment. The reporting provision applies to premiums paid after February 8, 1999 (determined as if the excise tax imposed under the provision applied to premiums paid after that date).

No inference is intended that a charitable contribution deduction was allowed under prior law with respect to a charitable split-dol-

lar insurance arrangement. The provision does not change the rules with respect to fraud or criminal or civil penalties under prior or present law; thus, actions constituting fraud or that are subject to penalties under prior or present law would still constitute fraud or be subject to the penalties after enactment of the provision.

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

8. Distributions by a partnership to a corporate partner of stock in another corporation (sec. 538 of the Tax Relief Extension Act and new sec. 732(f) of the Code)

Present and Prior Law

Present and prior law generally provide that no gain or loss is recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation in which it holds 80 percent of the stock (by vote and value) (sec. 332). The basis of property received by a corporate distributee in the distribution in complete liquidation of the 80-percent-owned subsidiary is a carryover basis, i.e., the same as the basis in the hands of the subsidiary (provided no gain or loss is recognized by the liquidating corporation with respect to the distributed property) (sec. 334(b)).

Present and prior law provide two different rules for determining a partner's basis in distributed property, depending on whether or not the distribution is in liquidation of the partner's interest in the partnership. Generally, a substituted basis rule applies to property distributed to a partner in liquidation. Thus, the basis of property distributed in liquidation of a partner's interest is equal to the partner's adjusted basis in its partnership interest (reduced by any money distributed in the same transaction) (sec. 732(b)).

By contrast, generally, a carryover basis rule applies to property distributed to a partner other than in liquidation of its partnership interest, subject to a cap (sec. 732(a)). Thus, in a non-liquidating distribution, the distributee partner's basis in the 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 its partnership interest (reduced by any money distributed in the same transaction). In a non-liquidating distribution, the partner's basis in its partnership interest is reduced by the amount of the basis to the distributee partner of the property distributed and is reduced by the amount of any money distributed (sec. 733).

If corporate stock is distributed by a partnership to a corporate partner with a low basis in its partnership interest, the basis of the stock is reduced in the hands of the partner so that the stock basis equals the distributee partner's adjusted basis in its partnership interest. Under prior law, no comparable reduction was made in the basis of the corporation's assets, however. Under prior law, the

effect of reducing the stock basis could be negated by a subsequent liquidation of the corporation under section 332.[58]

Reasons for Change

The Congress was concerned that the downward adjustment to the basis of property distributed by a partnership may be nullified if the distributed property is corporate stock. The distributed corporation could be liquidated by the corporate partner, so that the stock basis adjustment would have no effect. Similarly, if the corporations file a consolidated return, their taxable income may be computed without reference to the downward adjustment to the basis of the stock. These results could occur either if the partnership has contributed property to the distributed corporation, or if the property was held by the corporation before the distribution. Therefore, the provision requires a basis reduction to the property of the distributed corporation.

Explanation of Provision

In general

The provision provides for a basis reduction to assets of a corporation, if stock in that corporation is distributed by a partnership to a corporate partner. The reduction applies if, after the distribution, the corporate partner controls the distributed corporation.

Amount of the basis reduction

Under the provision, the amount of the reduction in basis of property of the distributed corporation generally equals the amount of the excess of (1) the partnership's adjusted basis in the stock of the distributed corporation immediately before the distribution, over (2) the corporate partner's basis in that stock immediately after the distribution.

The provision limits the amount of the basis reduction in two respects. First, the amount of the basis reduction may not exceed the amount by which (1) the sum of the aggregate adjusted bases of the property and the amount of money of the distributed corporation exceeds (2) the corporate partner's adjusted basis in the stock of the distributed corporation. Thus, for example, if the distributed corporation has cash of $300 and other property with a basis of $600 and the corporate partner's basis in the stock of the distributed corporation is $400, then the amount of the basis reduction could not exceed $500 (i.e., ($300 + $600) − $400 = $500).

Second, the amount of the basis reduction may not exceed the adjusted basis of the property of the distributed corporation. Thus, the basis of property (other than money) of the distributed corporation could not be reduced below zero under the provision, even though the total amount of the basis reduction would otherwise be greater.

The provision provides that the corporate partner recognizes long-term capital gain to the extent the amount of the basis reduc-

[58] In a similar situation involving the purchase of stock of a subsidiary corporation as replacement property following an involuntary conversion, the Code generally requires the basis of the assets held by the subsidiary to be reduced to the extent that the basis of the stock in the replacement corporation itself is reduced (sec. 1033).

tion exceeds the basis of the property (other than money) of the distributed corporation. In addition, the corporate partner's adjusted basis in the stock of the distribution is increased in the same amount. For example, if the amount of the basis reduction were $400, and the distributed corporation has money of $200 and other property with an adjusted basis of $300, then the corporate partner would recognize a $100 capital gain under the provision. The corporate partner's basis in the stock of the distributed corporation is also increased by $100 in this example, under the provision.

The basis reduction is allocated among assets of the controlled corporation in accordance with the rules provided under section 732(c).

Partnership distributions resulting in control

The basis reduction generally applies with respect to a partnership distribution of stock if the corporate partner controls the distributed corporation immediately after the distribution or at any time thereafter. For this purpose, the term control means ownership of stock meeting the requirements of section 1504(a)(2) (generally, an 80–percent vote and value requirement).[59]

The provision applies to reduce the basis of any property held by the distributed corporation immediately after the distribution, or, if the corporate partner does not control the distributed corporation at that time, then at the time the corporate partner first has such control. The provision does not apply to any distribution if the corporate partner does not have control of the distributed corporation immediately after the distribution and establishes that the distribution was not part of a plan or arrangement to acquire control.

For purposes of the provision, if a corporation acquires (other than in a distribution from a partnership) stock the basis of which is determined (by reason of being distributed from a partnership) in whole or in part by reference to section 732(a)(2) or (b), then the corporation is treated as receiving a distribution of stock from a partnership. For example, if a partnership distributes property other than stock (such as real estate) to a corporate partner, and that corporate partner contributes the real estate to another corporation in a section 351 transaction, then the stock received in the section 351 transaction is not treated as distributed by a partnership, and the basis reduction under this provision does not apply. As another example, if a partnership distributes stock to two corporate partners, neither of which have control of the distributed corporation, and the two corporate partners merge and the survivor obtains control of the distributed corporation, the stock of the distributed corporation that is acquired as a result of the merger is treated as received in a partnership distribution; the basis reduction rule of the provision applies.

In the case of tiered corporations, a special rule provides that if the property held by a distributed corporation is stock in a corpora-

[59] Note that a technical correction to this provision was enacted in The Community Renewal Tax Relief Act of 2000 (106th Cong., 2d Sess., P.L. 106–554) (described in this volume). Section 311(c) of H.R. 5662 as incorporated in that Act provides that the rule in the consolidated return regulations (Treas. Reg. sec. 1.1502–34) aggregating stock ownership for purposes of section 332 (relating to complete liquidation of a subsidiary that is a controlled corporation) also applies for purposes of section 732(f) (relating to basis adjustments to assets of a controlled corporation received in a partnership distribution).

tion that the distributed corporation controls, then the provision is applied to reduce the basis of the property of that controlled corporation. The provision is also reapplied to any property of any controlled corporation that is stock in a corporation that it controls. Thus, for example, if stock of a controlled corporation is distributed to a corporate partner, and the controlled corporation has a subsidiary, the amount of the basis reduction allocable to stock of the subsidiary is applied again to reduce the basis of the assets of the subsidiary, under the special rule.

The provision also provides for regulations, including regulations to avoid double counting and to prevent the abuse of the purposes of the provision. It is intended that regulations prevent the avoidance of the purposes of the provision through the use of tiered partnerships.

Effective Date

The provision is effective generally for distributions made after July 14, 1999. However, in the case of a corporation that is a partner in a partnership as of July 14, 1999, the provision is effective for any distribution made (or treated as made) to that partner from that partnership after June 30, 2001. In the case of any such distribution after the date of enactment and before July 1, 2001, the rule of the preceding sentence does not apply unless that partner makes an election to have the rule apply to the distribution on the partner's return of Federal income tax for the taxable year in which the distribution occurs.

No inference is intended that distributions that are not subject to the provision achieve a particular tax result under present law, and no inference is intended that enactment of the provision limits the application of tax rules or principles under present or prior law.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $2 million in 2000, $4 million in 2001, $7 million in 2002, and $10 million in each of the years 2003 through 2010.

B. Provisions Relating to Real Estate Investment Trusts (sec. 541–547, 551, 556, 561, 566, and 571 of the Tax Relief Extension Act and secs. 852, 856, 857, and 6655 of the Code)

1. General provisions

Present and Prior Law

A real estate investment trust ("REIT") is an entity that receives most of its income from passive real-estate related investments and that essentially receives pass-through treatment for income that is distributed to shareholders.

If an electing entity meets the requirements for REIT status, the portion of its income that is distributed to the investors each year generally is taxed to the investors without being subjected to a tax at the REIT level. In general, a REIT must derive its income from passive sources and not engage in any active trade or business.

A REIT must satisfy a number of tests on an annual basis that relate to the entity's (1) organizational structure; (2) source of income; (3) nature of assets; and (4) distribution of income. Under the source-of-income tests, at least 95 percent of its gross income generally must be derived from rents from real property, dividends, interest, and certain other passive sources (the "95 percent test"). In addition, at least 75 percent of its gross income generally must be from real estate sources, including rents from real property and interest on mortgages secured by real property. For purposes of the 95 and 75 percent tests, qualified income includes amounts 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 on indebtedness which such property secured.

In general, for purposes of the 95 percent and 75 percent tests, rents from real property do not include amounts for services to tenants or for managing or operating real property. However, there are some exceptions. Qualified rents include amounts received for services that are "customarily furnished or rendered" in connection with the rental of real property, so long as the services are furnished through an independent contractor from whom the REIT does not derive any income. Amounts received for services that are not "customarily furnished or rendered" are not qualified rents.

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 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. In addition, a REIT cannot derive any income from an independent contractor.

Rents for certain personal property leased in connection with real property are treated as rents from real property if the adjusted basis of the personal property does not exceed 15 percent of the aggregate adjusted bases of the real and the personal property.

In general, rents from real property do not include amounts received from any corporation if the REIT owns 10 percent or more of the voting power or of the total number of shares of all classes of stock of such corporation. Similarly, in the case of other entities, rents are not qualified if the REIT owns 10 percent of more in the assets or net profits of such person.

At the close of each quarter of the taxable year, at least 75 percent of the value of total REIT assets must be represented by real estate assets, cash and cash items, and Government securities. Also, 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, under prior law, a REIT could not own 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 of any corporate issuer. Securities for purposes of these rules are defined by reference to the Investment Company Act of 1940.[60]

[60] 15 U.S.C. 80a–1 and following. See Code section 856(c)(5)(F).

Under an exception to the ownership rule, a REIT is permitted to have a wholly owned subsidiary corporation, but the assets and items of income and deduction of such corporation are treated as those of the REIT, and thus can affect the qualification of the REIT under the income and asset tests.

A REIT generally is required to distribute 95 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 REITS and RICs can make certain "deficiency dividends" after the close of the taxable year, and have these treated as made before the end of the year. The regulations applicable to REITS state that a distribution will be treated as a "deficiency dividend" (and, thus, as made before the end of the prior taxable year) only to the extent the earnings and profits for that year exceed the amount of distributions actually made during the taxable year.[61]

A REIT that has been or has combined with a C corporation[62] will be disqualified if, as of the end of its taxable year, it has accumulated earnings and profits from a non-REIT year. A similar rule applies to regulated investment companies ("RICs"). In the case of a REIT, any distribution made in order to comply with this requirement is treated as being first from pre-REIT accumulated earnings and profits. RICs do not have a similar ordering rule.

In the case of a RIC, any distribution made within a specified period after determination that the investment company did not qualify as a RIC for the taxable year will be treated as applying to the RIC for the non-RIC year, "for purposes of applying [the earnings and profits rule that forbids a RIC to have non-RIC earnings and profits] to subsequent taxable years." The REIT rules do not specify any particular separate treatment of distributions made after the end of the taxable year for purposes of the earnings and profits rule. Treasury regulations under the REIT provisions state that "distribution procedures similar to those . . . for regulated investment companies apply to non-REIT earnings and profits of a real estate investment trust."[63]

Reasons for Change

The Congress was concerned that nonqualified income of a REIT might be avoided under prior law through transactions with entities that engaged in activities producing nonqualified income and that were effectively owned by the REIT. For example, a REIT might invest in an entity in which it owned virtually all the value (e.g., through preferred stock) even though it owned only a small amount of the vote. The remainder of the voting power might be held by persons related to the REIT such as its officers, directors, or employees. The REIT might effectively be a beneficiary of virtually all the earnings of the entity, through its preferred stock

[61] Treas. Reg. sec. 1.858–1(b)(2).

[62] A "C corporation" is a corporation that is subject to taxation under the rules of subchapter C of the Internal Revenue Code, which generally provides for a corporate level tax on corporate income. Thus, a C corporation is not a pass-through entity. Earnings and profits of a C corporation, when distributed to shareholders, are taxed to the shareholders as dividends.

[63] Treas. Reg. sec. 1.857–11(c).

ownership. Also, the REIT might hold significant debt in the entity, and receive significant interest income that reduced the entity's taxable income (subject to corporate level tax if the entity is a C corporation) while producing permissible income to the REIT.

Similarly, if the entity was a partnership engaged in activities that would generate nonqualified income for the REIT if done directly, the REIT might use a significant debt investment in the partnership combined with a small equity interest, to reduce the amount of nonqualified income the REIT would report from the partnership through its partnership interest, while still receiving a significant income stream through the debt.

As a result of these concerns, the Congress believed that a 10-percent value, as well as a 10-percent vote test, generally is appropriate to test the permitted relationship of a REIT to the entities in which it invests.

The Congress believed however, that certain types of activities that relate to the REIT's real estate investments should be permitted to be performed under the control of the REIT, through the establishment of a "taxable REIT subsidiary" where there are rules which limit the amount of the subsidiary's income that can be reduced through transactions with the REIT. A limit on the amount of REIT asset value that can be represented by investment in such subsidiaries was also desirable. In addition, the Congress believed it is desirable to obtain information regarding the extent of use of the new taxable REIT subsidiaries and the amount of corporate Federal income tax that such subsidiaries are paying. One type of activity is the provision of tenant services that the REIT wishes to provide in order to remain competitive that might not be considered customary because they are relatively new or "cutting-edge". The Congress believed that provision of tenant services by taxable REIT subsidiaries will simplify such rental operations since uncertainty whether a particular service provided by a subsidiary is "customary" will not affect the parent's qualification as a REIT. Another type of activity that the Congress believed appropriate for a subsidiary is management and operation of the real estate in which a REIT has developed expertise with respect to its own properties that it also would like to provide to third parties.

The Congress believed that allowing operation of health care facilities directly by a REIT for a limited period of time is appropriate to assure continuous provision of health care services where the facilities are acquired by the REIT upon termination of a lease (as upon foreclosure) where there may not be enough time to obtain a new independent provider of such health care services.

Finally, the Congress believed that a number of other simplifying changes are desirable, including simplifying the determination whether a publicly traded entity is an independent contractor and modifying and conforming certain RIC and REIT distribution rules.

Explanation of Provision

Investment limitations and taxable REIT subsidiaries

Investment limitations

General rule.—Under the provision, a REIT generally cannot own more than 10 percent of the total value of securities of a single

issuer, in addition to the prior law rule that a REIT cannot own more than 10 percent of the outstanding voting securities of a single issuer. In addition, no more than 20 percent of the value of a REIT's assets can be represented by securities (as defined in the Investment Company Act of 1940) of taxable REIT subsidiaries that are permitted under the Act.

Exception for safe-harbor debt.—For purposes of the new 10-percent value test, securities generally are defined to exclude safe harbor "straight debt" owned by a REIT (as defined in Code sections 1361(c)(5)(B)(i) and (ii)) if the issuer is an individual, or if the REIT (and any taxable REIT subsidiary of such REIT) owns no other securities of the issuer. However, in the case of a REIT that owns securities of a partnership, safe harbor debt is excluded from the definition of securities only if the REIT owns at least 20-percent or more of the profits interest in the partnership. The purpose of the partnership rule requiring a 20 percent profits interest is to assure that if the partnership produces income that would be disqualified income to the REIT, the REIT will be treated as receiving a significant portion of that income directly through its partnership interest, even though it also may derive qualified interest income through its safe harbor debt interest.

Exception for taxable REIT subsidiaries

In general.—An exception to the limitations on ownership of securities of a single issuer applies in the case of a "taxable REIT subsidiary" that meets certain requirements. However, securities (as defined in the Investment Company Act of 1940) of taxable REIT subsidiaries cannot not exceed 20 percent of the total value of a REIT's assets.

Joint election requirement.—To qualify as a taxable REIT subsidiary, both the REIT and the subsidiary corporation must join in an election. In addition, any corporation (other than a REIT or a qualified REIT subsidiary under section 856(i) that does not properly elect with the REIT to be a taxable REIT subsidiary) of which a taxable REIT subsidiary owns, directly or indirectly, more than 35 percent of the vote or value is automatically treated as a taxable REIT subsidiary.

Permitted activities of a taxable REIT subsidiary.—A taxable REIT subsidiary can engage in certain business activities that under prior law could disqualify the REIT because, but for the provision, the taxable REIT subsidiary's activities and relationship with the REIT would have prevented certain income from qualifying as rents from real property. Specifically, the subsidiary can provide services to tenants of REIT property (even if such services were not considered services customarily furnished in connection with the rental of real property), and can manage or operate properties, generally for third parties, without causing amounts received or accrued directly or indirectly by the REIT for such activities to fail to be treated as rents from real property. However, rents paid to a REIT generally are not qualified rents if the REIT owns more than 10 percent of the value (as well as of the vote) of a corporation paying the rents. The only exceptions are for rents that are paid by taxable REIT subsidiaries and that also meet a limited rental exception (where 90 percent of space is leased to third par-

ties at comparable rents) and an exception for rents from certain lodging facilities (operated by an independent contractor).

However, the subsidiary cannot directly or indirectly operate or manage a lodging or healthcare facility. Nevertheless, it can lease a qualified lodging facility (e.g., a hotel) from the REIT (provided no gambling revenues were derived by the hotel or on its premises); and the rents paid are treated as rents from real property so long as the lodging facility was operated by an independent contractor for a fee. The subsidiary can bear all expenses of operating the facility and receive all the net revenues, minus the independent contractor's fee.

For purposes of the rule that an independent contractor may operate a qualified lodging facility, an independent contractor will qualify so long as, at the time it enters into the management agreement with the taxable REIT subsidiary, it is actively engaged in the trade or business of operating qualified lodging facilities for any person who is not related to the REIT or the taxable REIT subsidiary. The REIT may receive income from such an independent contractor with respect to certain pre-existing leases.

Also, the subsidiary generally cannot provide to any person rights to any brand name under which hotels or healthcare facilities are operated. An exception applies to rights provided to an independent contractor to operate or manage a lodging facility, if the rights are held by the subsidiary as licensee or franchisee, and the lodging facility is owned by the subsidiary or leased to it by the REIT.

Special rules to limit income of taxable REIT subsidiary going to REIT.—Interest paid by a taxable REIT subsidiary to the related REIT is subject to the earnings stripping rules of section 163(j). Thus the taxable REIT subsidiary cannot deduct interest in any year that would exceed 50 percent of the subsidiary's adjusted gross income.

If any amount of interest, rent, or other deductions of the taxable REIT subsidiary for amounts paid to the REIT is determined to be other than at arm's length ("redetermined" items), an excise tax of 100 percent is imposed on the portion that was excessive. "Safe harbors" are provided for certain rental payments where (1) the amounts are de minimis, (2) there is specified evidence that charges to unrelated parties are substantially comparable, (3) certain charges for services from the taxable REIT subsidiary are separately stated, or (4) the subsidiary's gross income from the service is not less than 150 percent of the subsidiary's direct cost in furnishing the service.[64]

In determining whether rents are arm's length rents, the fact that such rents do not meet the requirements of the specified safe harbors shall not be taken into account. In addition, rent received by a REIT shall not fail to qualify as rents from real property by reason of the fact that all or any portion of such rent is redetermined for purposes of the excise tax.

Treasury study of taxable REIT subsidiaries.—The Treasury Department is to conduct a study to determine how many taxable

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[64] A technical correction described below (sec. 311(b) of H.R. 5662) clarified that redetermined rent does not include any amount received from a taxable REIT subsidiary that would be excluded from unrelated business taxable income (under section 512(b)(3)).

REIT subsidiaries are in existence and the aggregate amount of taxes paid by such subsidiaries and shall submit a report to the Congress describing the results of such study.

Health care REITS

The provision permits a REIT to own and operate a health care facility for at least two years, and treat it as permitted "foreclosure" property, if the facility is acquired by the termination or expiration of a lease of the property. Extensions of the 2–year period can be granted.

Conformity with regulated investment company rules

Under the provision, the REIT distribution requirements are modified to conform to the rules for regulated investment companies. Specifically, a REIT is required to distribute only 90 percent, rather than 95 percent, of its income.

Definition of independent contractor

If any class of stock of the REIT or the person being tested as an independent contractor is regularly traded on an established securities market, only persons who directly or indirectly own 5 percent or more of such class of stock shall be counted in determining whether the 35 percent ownership limitations have been exceeded.

Modification of earnings and profits rules for RICs and REITS

The rule allowing a RIC to make a distribution after a determination that it had failed RIC status, and thus meet the requirement of no non-RIC earnings and profits in subsequent years, is modified to clarify that, when the sole reason for the determination is that the RIC had non-RIC earnings and profits in the initial year (i.e. because it was determined not to have distributed all C corporation earnings and profits), the procedure would apply to permit RIC qualification in the initial year to which such determination applied, in addition to subsequent years.

The provision modifies both the RIC and REIT earnings and profits rules to provide a more specific ordering rule, similar to the present-law REIT rule. The new ordering rule treats a distribution to meet the requirement of no non-RIC or non-REIT earnings and profits as coming, on a first-in, first-out basis, from earnings and profits which, if not distributed, would result in a failure to meet such requirement. Thus, such earnings and profits are deemed distributed first from earnings and profits that would cause such a failure, starting with the earliest RIC or REIT year for which such failure would occur. In addition, the REIT deficiency dividend rules are modified to take account of this ordering rule.

Provision regarding rental income from certain personal property

The provision modifies the rule permitting certain rents from personal property to be treated as real estate rental income if such personal property did not exceed 15 percent of the aggregate of real and personal property. The provision replaces the prior law com-

parison of the adjusted bases of properties with a comparison based on fair market values.

Effective Date

In general.—The provision is effective for taxable years beginning after December 31, 2000. The provision with respect to modification of earnings and profits rules is effective for distributions after December 31, 2000.

Transition rules.—The new rules forbidding a REIT to own more than 10 percent of the value of securities of a single issuer do not apply to a REIT with respect to securities held directly or indirectly by such REIT on July 12, 1999, or acquired pursuant to the terms of a written binding contract in effect on that date and at all times thereafter until the acquisition. Securities received in a tax-free exchange or reorganization, with respect to or in exchange for such grandfathered securities, are also grandfathered.

The grandfathering of securities ceases to apply if the REIT acquires additional securities of that issuer after July 12,1999, other than pursuant to a binding contract in effect on that date and at all times thereafter, or in a reorganization with another corporation the securities of which are grandfathered.

This transition also ceases to apply to securities of a corporation as of the first day after July 12, 1999, on which such corporation engages in a substantial new line of business, or acquires any substantial asset, other than pursuant to a binding contract in effect on such date and at all times thereafter, or in a reorganization or transaction in which gain or loss is not recognized by reason of section 1031 or 1033 of the Code. If a corporation makes an election to become a taxable REIT subsidiary, effective before January 1, 2004, and at a time when the REIT's ownership is grandfathered under these rules, the election is treated as a reorganization under section 368(a)(1)(A) of the Code.

Qualified rents.—The new 10 percent of value limitation for purposes of defining qualified rents is effective for taxable years beginning after December 31, 2000. There is an exception for rents paid under a lease or pursuant to a binding contract in effect on July 12, 1999, and at all times thereafter.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $46 million in 2001, $136 million in 2002, $49 million in 2003, and $24 million in 2004, and is estimated to reduce Federal fiscal year budget receipts by $4 million in 2005, $34 million in 2006, $67 million in 2007, $101 million in 2008, $140 million in 2009, and $182 million in 2010.

2. Modification of estimated tax rules for closely held REITs

Present and Prior Law

If a person has a direct interest or a partnership interest in assets that produce income throughout the year (including mortgages or other securities), that person's estimated tax payments must reflect the quarterly amounts expected from the asset. However,

under prior law, a dividend distribution of earnings from a real estate investment trust ("REIT") was considered for estimated tax purposes to produce income when the dividend is paid.

Reasons for Change

The Congress was concerned that REITs might be used to defer estimated taxes. Income producing property might be acquired in or transferred to a REIT, and a dividend paid from the REIT only at the end of the year. So long as the dividend was paid by year end (or within a certain period after year end), the REIT pays no tax on the dividend, while the shareholder of the REIT did not include the payment in income until the dividend is paid. Thus, the income from the assets was not counted in the earlier quarters of the year, for purposes of the shareholder's estimated tax.

The Congress was concerned that this type of situation was most likely to occur in cases where a REIT is relatively closely held and might be used to structure payments for the benefit of significant shareholders. In such situations, the Congress believed that persons who are significant shareholders in the REIT should be able to obtain sufficient information regarding the quarterly income of the REIT to determine their share of that income for estimated tax purposes.

Explanation of Provision

Under the provision, in the case of a REIT that is closely held, any person owning at least 10 percent of the vote or value of the REIT is required to accelerate the recognition of year-end dividends attributable to the closely held REIT, for purposes of such person's estimated tax payments. A closely held REIT is defined as one in which at least 50 percent of the vote or value is owed by five or fewer persons. Attribution rules apply to determine ownership.

No inference is intended regarding the treatment of any transaction prior to the effective date.

Effective Date

The provision is effective for estimated tax payments due on or after December 15, 1999.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $40 million in 2000, and $1 million for each of the years 2001 through 2010.

PART FOUR: TRADE AND DEVELOPMENT ACT OF 2000 (PUBLIC LAW 106–200)[65]

A. Application of Denial of Foreign Tax Credit Regarding Trade and Investment With Respect to Certain Foreign Countries (sec. 601 of the Trade and Development Act and sec. 901(j) of the Code)

Present and Prior 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 can 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.

Pursuant to special rules applicable to taxes paid to certain foreign countries, no foreign tax credit is allowed for income, war profits, or excess profits taxed paid, accrued, or deemed paid to a country which satisfies specified criteria, to the extent that the taxes are with respect to income attributable to a period during which such criteria were satisfied (sec. 901(j)). Section 901(j) applies with respect to any foreign country: (1) the government of which the United States does not recognize, unless such government is otherwise eligible to purchase defense articles or services under the Arms Export Control Act, (2) with respect to which the United States has severed diplomatic relations, (3) with respect to which the United States has not severed diplomatic relations but does not conduct such relations, or (4) which the Secretary of State has, pursuant to section 6(j) of the Export Administration Act of 1979, as amended, designated as a foreign country which repeatedly provides support for acts of international terrorisms (a "section 901(j) foreign country"). The denial of credits applies to any foreign country during the period beginning on the later of January 1, 1987, or six months after such country becomes a section 901(j) country, and ending on the date the Secretary of State certifies to the Secretary of the Treasury that such country is no longer a section 901(j) country.

[65] H.R. 434 ("Trade and Development Act of 2000"); P.L. 106–200. On November 3, 1999, the Senate passed a version of H.R. 434 ("Trade and Development Act of 1999") which included provisions relating to the waiver of denial of foreign tax credits under section 901(j) and the acceleration of rum cover over payments to Puerto Rico and the Virgin Islands. The Senate amendment to H.R. 434 relating to the waiver of denial of foreign tax credits under section 901(j) is similar to a provision included in the conference agreement to H.R. 2488 ("Taxpayer Refund and Relief Act of 1999") (H. Rep. 106–289). The Senate amendment to H.R. 434 relating to the rum cover over payments to Puerto Rico and the Virgin Islands is the same as a provision included in H.R. 984 ("Caribbean and Central America Relief and Economic Stabilization Act") as reported by the House Committee on Ways and Means on March 13, 2000 (H. Rep. 106–519, Part 1). The conference agreement to H.R. 434 was reported on May 4, 2000 (H. Rep. 106–606). The conference agreement to H.R. 434 was passed by the House on May 4, 2000 and by the Senate on May 11, 2000. H.R. 434 was signed by the President on May 18, 2000.

Taxes treated as noncreditable under section 901(j) generally are permitted to be deducted notwithstanding the fact that the taxpayer elects use of the foreign tax credit for the taxable year with respect to other taxes. In addition, income for which foreign tax credits are denied generally cannot be sheltered from U.S. tax by other creditable foreign taxes.

Under the rules of subpart F, U.S. 10-percent shareholders of a controlled foreign corporation ("CFC") are required to include in income currently certain types of income of the CFC, whether or not such income is actually distributed currently to the shareholders (referred to as "subpart F income"). Subpart F income includes income derived from any foreign country during a period in which the taxes imposed by that country are denied eligibility for the foreign tax credit under section 901(j) (sec. 952(a)(5)).

Reasons for Change [66]

The Congress has observed that the automatic denial of foreign tax credits under section 901(j) with respect to a foreign country may in certain cases conflict with other policy interests of the United States. The Congress believed that it is appropriate to provide a mechanism for the waiver of the denial of foreign tax credits in certain cases.

Explanation of Provision

The provision provides that section 901(j) no longer applies with respect to a foreign country if: (1) the President determines that a waiver of the application of section 901(j) to such foreign country is in the national interest of the United States and will expand trade and investment opportunities for U.S. companies in such foreign country, and (2) the President reports to Congress, not less than 30 days before the waiver is granted, the intention to grant such a waiver and the reason for such waiver.

Effective Date

The provision is effective on or after February 1, 2001.

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

B. Acceleration of Coverover Payments to Puerto Rico and the Virgin Islands (sec. 602 of the Trade and Development Act and sec. 7652 of the Code)

Present and Prior Law

A $13.50 per proof gallon [67] excise tax is imposed on distilled spirits produced in, or imported or brought into, the United States.

[66] The legislative history of this provision did not include a reasons for change section. The reasons for change reported here are drawn from the reasons for change reported in a House Committee on Ways and Means report to H.R. 2488 ("Financial Freedom Act of 1999") with respect to a similar provision concerning the waiver of denial of foreign tax credits under section 901(j). See H. Rep. 106–238 at 255–256 (1999).

[67] A proof gallon is a liquid gallon consisting of 50 percent alcohol.

The excise tax does not apply to distilled spirits that are exported from the United States or to distilled spirits that are consumed in U.S. possessions (e.g., Puerto Rico and the Virgin Islands).

The Code provides for coverover (payment) of $13.25 per proof gallon of the excise tax imposed on rum imported (or brought) into the United States (without regard to the country of origin) to Puerto Rico and the Virgin Islands during the period July 1, 1999 through December 31, 2001. Effective on January 1, 2002, the coverover rate is scheduled to return to its permanent level of $10.50 per proof gallon. Under prior law, the maximum amount attributable to the increased coverover rate over the permanent rate of $10.50 per proof gallon that could be paid to Puerto Rico and the Virgin Islands before October 1, 2000 was $20 million. Payment of this amount was made on January 3, 2000.[68] Any remaining amounts attributable to the increased coverover rate were to be paid on October 1, 2000.

Amounts covered over to Puerto Rico and the Virgin Islands are deposited into the treasuries of the two possessions for use as those possessions determine.

Explanation of Provision

The provision provides that unpaid amounts attributable to the increase in the coverover rate to $13.25 per proof gallon for the period from July 1, 1999 through the last day of the month prior to the date of enactment would be paid on the first monthly payment date following the date of enactment.[69] With respect to amounts attributable to the period beginning with the month of the provision's enactment, payments are based on the full $13.25 per proof gallon rate.

The provision further includes two clarifications to the rules governing coverover payments. First, clarification is provided that payments to the Virgin Islands with respect to rum imported from that possession are to be made annually in advance (based on estimates) as is the current administrative practice. Second, the provision clarifies that the Internal Revenue Code provisions governing coverover payments are the exclusive source of authority for making these payments.

Effective Date

The provision became effective on the date of enactment (May 18, 2000).

[68] The Department of the Interior, which administers the coverover for rum imported into the United States from the U.S. Virgin Islands, erroneously authorized full payment to the Virgin Islands of the increased coverover rate on that rum notwithstanding the statutory limit on these transfers for periods before October 1, 2000. The Bureau of Alcohol, Tobacco, and Firearms, which administers the coverover payments for the Virgin Islands' portion of tax collected on rum imported from other countries, complied with the statutory limit.

[69] Thus, this provision applies only to payments to Puerto Rico and to payments of the Virgin Islands' portion of tax on rum imported from other countries because the Interior Department erroneously has already paid in full amounts attributable to rum imported from the Virgin Islands.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget outlays by $51 million in 2000 and to reduce Federal fiscal year budget outlays by $51 million in 2001.

PART FIVE: AMENDING THE INTERNAL REVENUE CODE TO REQUIRE SECTION 527 ORGANIZATIONS TO DISCLOSE THEIR POLITICAL ACTIVITIES (PUBLIC LAW 106–230) [70]

Present and Prior Law

Under present law, section 527 provides a limited tax-exempt status to "political organizations," meaning a party, committee, association, fund, account, or other organization (whether or not incorporated) organized and operated primarily for the purpose of directly or indirectly accepting contributions or making expenditures (or both) for an "exempt function." These organizations are generally exempt from Federal income tax on contributions they receive, but are subject to tax on their net investment income and certain other income at the highest corporate income tax rate (currently 35 percent). Donors are exempt from gift tax on their contributions to such organizations. For purposes of section 527, the term "exempt function" means: the function of influencing or attempting to influence the selection, nomination, election, or appointment of any individual to any Federal, State, or local public office or office in a political organization, or the election of Presidential or Vice-Presidential electors, whether or not such individual or electors are selected, nominated, elected, or appointed. Thus, by definition, the purpose of a section 527 organization is to accept contributions or make expenditures for political campaign (and similar) activities.

Under prior law, section 527 organizations were subject to no notification requirement when they were formed and there was no separate application for recognition of status as a section 527 organization. However, a section 527 organization wishing to receive confirmation of its status as a section 527 organization could request a written determination from the IRS in the form of a private letter ruling.

Under present and prior law, a section 527 organization generally is required annually to file Form 1120–POL (Return of Organization Exempt from Income Tax). A section 527 organization was not required to disclose its Form 1120–POL to the general public and such return was not required to be made available to the public by the IRS.

[70] H.R. 4762 was introduced in the House of Representatives and was passed under suspension of the rules on June 27, 2000. The bill passed the Senate without amendment on June 29, 2000, and was signed by the President on July 1, 2000 (P.L. 106–230). The bill was not reported by any Committee of the House of Representatives or the Senate. Therefore, the bill does not have any formal legislative history. This description of the provisions of the bill was prepared by the staff of the Joint Committee on Taxation.

Explanation of Provisions[71]

Notice of section 527 organization

Under the provision, an organization is not treated as a section 527 organization unless it has given notice to the Secretary of the Treasury, electronically and in writing, that it is a section 527 organization. The notice is not required (1) of any person required to report as a political committee under the Federal Election Campaign Act of 1971, (2) by organizations that reasonably anticipate that their annual gross receipts will always be less than $25,000, and (3) organizations described in section 501(c). All other organizations, including State and local candidate committees, are required to file the notice.

The notice is required to be transmitted no later than 24 hours after the date on which the organization is organized. The notice is required to include the following information: (1) the name and address of the organization and its electronic mailing address, (2) the purpose of the organization, (3) the names and addresses of the organization's officers, highly compensated employees, contact person, custodian of records, and members of the organization's Board of Directors, (4) the name and address of, and relationship to, any related entities, and (5) such other information as the Secretary may require.

The notice of status as a section 527 organization is required to be disclosed to the public by the IRS and by the organization. In addition, the Secretary of the Treasury is required to make publicly available on the Internet and at the offices of the IRS a list of all political organizations that file a notice with the Secretary under section 527 and the name, address, electronic mailing address, custodian of records, and contact person for such organization. The IRS is required to make this information available within 5 business days after the Secretary of the Treasury receives a notice from a section 527 organization.

Disclosure by political organizations of expenditures and contributors

A political organization that accepts a contribution or makes an expenditure for an exempt function during any calendar year is required to file with the Secretary of the Treasury certain reports. The following reports are required: either (1) in the case of a calendar year in which a regularly scheduled election is held, quarterly reports, a pre-election report, and a post-general election report and, in the case of any other calendar year, a report covering January 1 to June 30 and July 1 to December 31, or (2) monthly reports for the calendar year, except that, in lieu of the reports due for November and December of any year in which a regularly scheduled general election is held, a pre-general election report, a post-general election report, and a year end report are to be filed.

The reports are required to include the following information: (1) the amount of each expenditure made to a person if the aggregate amount of expenditures to such person during the calendar year

[71] The IRS has issued guidance concerning the reporting requirements of section 527. See, Rev. Rul. 2000–49, IRB 2000–44 (October 30, 2000).

equals or exceeds $500 and the name and address of the person (in the case of an individual, including the occupation and name of the employer of the individual); and (2) the name and address (in the case of an individual, including the occupation and name of employer of such individual) of all contributors that contributed an aggregate amount of $200 or more to the organization during the calendar year and the amount of the contribution.

The disclosure requirements do not apply (1) to any person required to report as a political committee under the Federal Election Campaign Act of 1971, (2) to any State or local committee of a political party or political committee of a State or local candidate, (3) to any organization that reasonably anticipates that it will not have gross receipts of $25,000 or more for any taxable year, (4) to any organization described in section 501(c), or (5) with respect to any expenditure that is an independent expenditure (as defined in section 301 of the Federal Election Campaign Act of 1971).

For purposes of the disclosure requirements, the term "election" means (1) a general, special, primary, or runoff election for a Federal office, (2) a convention or caucus of a political party that has authority to nominate a candidate for Federal office, (3) a primary election held for the selection of delegates to a national nominating convention of a political party, or (4) a primary election held for the expression of a preference for the nomination of individuals for election to the office of President.

Under the provision, the IRS is required to make available to the public any report filed by a political organization. In addition, the organization is required to make any such report available to the public.

Return requirements for section 527 organizations

Under the provision, the annual return required to be filed by section 527 organizations is required to be made available to the public by the organization and by the IRS.

Effective Date

Under the provision, the notice of status as a section 527 organization is effective on the date of enactment (July 1, 2000). In the case of an existing section 527 organization, the notice is required within 30 days after the date of enactment. The disclosure of such notices is effective 45 days after the date of enactment.

The reporting of expenditures and contributions to any political organization is effective for expenditures made and contributions received after the date of enactment, except that the provision does not apply to expenditures made, or contributions received, after the date of enactment pursuant to a contract entered into on or before such date.

The provision requiring annual returns of section 527 organizations to be made publicly available is effective for returns for taxable years beginning after June 30, 2000.

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

PART SIX: MISCELLANEOUS TRADE AND TECHNICAL CORRECTIONS ACT OF 2000 (PUBLIC LAW 106–476) [72]

A. Imported Cigarette Compliance Act of 2000 (secs. 4001–4003 of the Miscellaneous Trade and Technical Corrections Act of 2000 and sec. 5754 of the Code)

Present and Prior Law

An excise tax equal to 34 cents per pack of 20 cigarettes is imposed on cigarettes manufactured, imported, or brought into the United States.[73] Separate taxes are imposed on other tobacco products, including cigars, smokeless tobacco, and pipe and roll-your-own tobacco. The taxes do not apply to tobacco products that are exported from the United States (including tobacco products shipped to Puerto Rico).

The Treasury Department is authorized to require tobacco products destined for export to be packaged in specially marked packages to distinguish the products from products for the U.S. domestic market. This packaging is a condition of removal from the manufacturers' premises without payment of tax. If products removed for export are diverted into the U.S. domestic market, numerous present and prior law sanctions apply. Any person (including a manufacturer, a wholesale distributor, or a retailer) who knowingly holds untaxed tobacco products removed for export for sale in the U.S. domestic market is subject to civil and/or criminal penalties for holding the tobacco products. Such a person further is liable as well for the tax (and for penalties for failure to pay the tax and to file a return, where appropriate). Finally, present law authorizes the Treasury Department to seize any export-labeled tobacco products found in the U.S. domestic market.

Present and prior law prohibit the re-importation of domestically manufactured tobacco products unless the cigarettes are returned to the premises of a manufacturer or an export warehouse proprietor.[74] Under prior law, the Treasury Department defined a manufacturer eligible to receive re-imported tobacco products as an entity that manufactured domestically at least as many cigarettes as it re-imported. Further, Treasury regulations required that any re-imported tobacco products be re-packaged in appropriate domestic market packaging before being removed (tax-paid) for sale in the

[72] For legislative background, see H.R. 4868, as reported by the Senate Finance Committee (S. Rep. 106–503, Oct. 12, 2000). The Senate passed H.R. 4868 by unanimous consent on October 13, 2000. The House agreed to the Senate-passed bill on October 24, 2000, with an amendment pursuant to H. Res. 644. On October 26, 2000, by unanimous consent, the Senate passed H.R. 4868, as amended by the House, the "Tariff Suspension Trade Act of 2000." The President signed the bill on November 9, 2000.

[73] Effective January 1, 2002, this tax rate is scheduled to increase to 39 cents per pack of 20 cigarettes. Tax rates on other tobacco products are scheduled to increase proportionately at that time.

[74] The term re-importation includes the bringing back into the United States of tobacco products that had been shipped to Puerto Rico.

U.S. domestic market. Tobacco products that entered the U.S. domestic market in violation of these rules were subject to seizure by the Federal Government and the person in whose possession they were found was subject to the penalties described above. Under prior law, the Treasury Department administratively determined how to dispose of forfeited products.

Explanation of Provisions

A technical correction is made to clarify that domestically produced cigarettes may be re-imported into the United States for personal use in quantities that are exempt from tax and duty under the Harmonized Tariff Schedule.[75]

The provision also codifies prior Treasury Department regulations on the disposition of domestically produced tobacco products that are re-imported or brought into the United States and modifies the regulations to limit the disposition of the tobacco products to return to the original manufacturer of the product or to an export warehouse proprietor authorized by the original manufacturer to receive the products. This codification retains without change the existing Treasury regulation requirement that re-imported tobacco products be re-packaged in appropriate domestic packaging before being removed (tax-paid) for sale in the U.S. domestic market.

The provision provides that tobacco products that are forfeited to the Federal Government must be destroyed (rather than being disposed of in any manner administratively determined by the Treasury Department). Finally, the provision expands the application of the special tax penalty for re-importing tobacco products to include the sale in the U.S. domestic market of tobacco products labeled for export (but not actually exported). Thus, this penalty can be imposed in addition to other penalties and sanctions that apply to tobacco products that might be removed for export, but instead are diverted into the U.S. domestic market.

Effective Date

The technical correction is effective as if included in the Balanced Budget Act of 1997.

The other provisions became effective on the date of enactment, except previously exported tobacco products are subject to the provision only if they are re-imported, or brought into the United States after the date of enactment.

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

[75] This technical correction subsequently was modified by the Community Renewal Tax Relief Act of 2000 (P.L. 106–554).

PART SEVEN: FSC REPEAL AND EXTRATERRITORIAL INCOME EXCLUSION ACT OF 2000 (PUBLIC LAW 106–519) [76]

Present and Prior Law

Summary of U.S. income taxation of foreign corporations

Under 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 a 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 those operations when the income is repatriated to the United States through a dividend distribution to the U.S. person.[77] 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. An indirect foreign tax credit may reduce the U.S. tax imposed on such income.

Foreign sales corporations

Under prior law, the income of an eligible foreign sales corporation ("FSC") was partially subject to U.S. income tax and partially exempt from U.S. income tax. In addition, a U.S. corporation generally was not subject to U.S. income tax on dividends distributed from the FSC out of certain earnings.

A FSC was required to be located and managed outside the United States and to perform certain economic processes outside the United States. A FSC was often owned by a U.S. corporation that produced goods in the United States. The U.S. corporation either supplied goods to the FSC for resale abroad or paid the FSC a commission in connection with such sales. The income of the FSC, a portion of which was exempt from U.S. income tax under the FSC rules, equaled the FSC's gross markup or gross commission income less the expenses incurred by the FSC. The gross

[76] H.R. 4986 ("FSC Repeal and Extraterritorial Income Exclusion Act of 2000"); P.L. 106–519. H.R. 4986 was reported by the House Committee on Ways and Means on July 27, 2000 (H. Rep. 106–845). H.R. 4986 was passed by the House on September 13, 2000. H.R. 4986 was reported by the Senate Committee on Finance with an amendment on September 19, 2000 (S. Rep. 106–416). The conference agreement to H.R. 2614 ("Enactment of Certain Small Business, Health, Tax, and Minimum Wage Provisions," H. Rep. 106–1004, Oct. 26, 2000) included legislation that resolved the differences between the House and Senate on this matter. On November 1, 2000, the Senate passed a version of H.R. 4986 which adopted the compromise language of the conference agreement to H.R. 2614. The House passed this compromise version of H.R. 4986 on November 14, 2000. H.R. 4986 was signed by the President on November 15, 2000.

[77] A variety of anti-deferral regimes impose current U.S. tax on income earned by a U.S. person through a foreign corporation. The Code sets forth the following anti-deferral regimes: the controlled foreign corporation rules of subpart F (secs. 951–954), 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 (sec. 1246). Detailed rules for coordination among the anti-deferral regimes are provided to prevent a U.S. person from being subject to U.S. tax on the same item of income under multiple regimes.

markup or the gross commission was determined according to specified pricing rules.

A FSC generally was not subject to U.S. income tax on its exempt foreign trade income. The exempt foreign trade income of a FSC was treated as foreign-source income that is not effectively connected with the conduct of a trade or business within the United States.

Foreign trade income, other than exempt foreign trade income, generally was treated as U.S.-source income effectively connected with the conduct of a trade or business conducted through a permanent establishment within the United States. Thus, a FSC's income, other than exempt foreign trade income, generally was subject to U.S. tax currently and was treated as U.S.-source income for purposes of the foreign tax credit limitation.

Foreign trade income of a FSC was defined as the FSC's gross income attributable to foreign trading gross receipts. Foreign trading gross receipts generally were the gross receipts attributable to the following types of transactions: the sale of export property; the lease or rental of export property; services related and subsidiary to such a sale or lease of export property; engineering and architectural services for projects outside the United States; and export management services. Investment income and carrying charges were excluded from the definition of foreign trading gross receipts.

The term "export property" generally meant property (1) which is manufactured, produced, grown or extracted in the United States by a person other than a FSC; (2) which is held primarily for sale, lease, or rental in the ordinary course of a trade or business for direct use or consumption outside the United States; and (3) not more than 50 percent of the fair market value of which is attributable to articles imported into the United States. The term "export property" did not include property leased or rented by a FSC for use by any member of a controlled group of which the FSC is a member; patents, copyrights (other than films, tapes, records, similar reproductions, and other than computer software, whether or not patented), and other intangibles; oil or gas (or any primary product thereof); unprocessed softwood timber; or products the export of which is prohibited or curtailed. Export property also excluded property designated by the President as being in short supply.

If export property was sold to a FSC by a related person (or a commission was paid by a related person to a FSC with respect to export property), the income with respect to the export transaction was required to be allocated between the FSC and the related person. The taxable income of the FSC and the taxable income of the related person were computed based upon a transfer price determined under section 482 or under one of two formulas specified in the FSC provisions.

The portion of a FSC's foreign trade income that was treated as exempt foreign trade income depended on the pricing rule used to determine the income of the FSC. If the amount of income earned by the FSC was based on section 482 pricing, the exempt foreign trade income generally was 30 percent of the foreign trade income the FSC derived from a transaction. If the income earned by the FSC was determined under one of the two formulas specified in the

FSC provisions, the exempt foreign trade income generally was 15/23 of the foreign trade income the FSC derived from the transaction.

A FSC was not required or deemed to make distributions to its shareholders. Actual distributions were treated as being made first out of earnings and profits attributable to foreign trade income, and then out of any other earnings and profits. A U.S. corporation generally was allowed a 100 percent dividends-received deduction for amounts distributed from a FSC out of earnings and profits attributable to foreign trade income. The 100 percent dividends-received deduction was not allowed for nonexempt foreign trade income determined under section 482 pricing. Any distribution made by a FSC out of earnings and profits attributable to foreign trade income to a foreign shareholder was treated as U.S.-source income effectively connected with a business conducted through a permanent establishment of the shareholder within the United States. Thus, the foreign shareholder was subject to U.S. tax on such a distribution.

Reasons for Change

The reasons for repealing the FSC rules and enacting an exclusion for extraterritorial income were expressed independently by the House Committee on Ways and Means in House Report 106–845 accompanying H.R. 4986 (the "FSC Repeal and Extraterritorial Income Exclusion Act of 2000") and by the Senate Committee on Finance in Senate Report 106–416, also accompanying H.R. 4986. Those reasons for change are restated below.

Report of the House Committee on Ways and Means

The Report of the House Committee on Ways and Means states:

In general

On February 24, 2000, the Appellate Body, over the objections of the United States, upheld the finding of the [World Trade Organization ("WTO") Dispute Settlement] Panel that had found that the FSC provisions of sections 921 through 927 of the Code constitute a prohibited export subsidy under the WTO Agreement on Subsidies and Countervailing Measures and under the Agreement on Agriculture. The Panel specified that "FSC subsidies must be withdrawn at the latest with effect from 1 October 2000." [78]

The purpose of this legislation is to comply with the recommendations and rulings of the Panel and the Appellate Body, as adopted by the WTO Dispute Settlement Body, in the dispute before the World Trade Organization entitled United States—Tax Treatment for "Foreign Sales Corporations," WT/DS108/R, WT/DS108/AB/R, Report of the Panel, as modified by the Appellate Body, adopted March 20, 2000.

The legislation complies with the Panel and Appellate Body Decisions by repealing the FSC provisions of the Code, thereby eliminating the measures which the Panel and Appellate Body found to be prohibited export subsidies. The legislation makes fundamental adjustments to the Code that move the U.S. tax system in the di-

[78] Report of the Panel at 334.

rection of many European tax systems by incorporating certain of the territorial features of those systems.

Before turning to the details of this legislation, however, the Committee feels compelled to make certain observations regarding the history of the FSC dispute, the actions of the European Union in initiating the dispute, and the decision of the Appellate Body. The origins of this dispute go back many years, and arise, in part, out of certain fundamental differences between tax systems. There are two basic types of income tax systems: (1) a residence-based (or "worldwide") system; and (2) a territorial system. Under a worldwide system, such as that of the United States, all of the income earned by a resident (e.g., a corporation incorporated in one of the fifty states or the District of Columbia) is subject to tax, regardless of where that income is earned. Under a territorial system, such as those of a number of European countries, only income earned within the borders of the taxing jurisdiction is subject to tax. In practice, neither the United States nor the member states of the European Union employ a "pure" territorial system or a "pure" worldwide system, as most countries employ some combination of the two concepts.

It is important to note that each type of system generally uses a different method to avoid double taxation of foreign-source income. Although this is an oversimplification, in a worldwide system, the "credit method" typically is used; that is, a tax credit is provided for taxes paid to foreign governments on income earned abroad. In a territorial system, the "exemption method" is used; that is, income earned abroad is simply not subject to tax. While tax policy arguments can be used to justify the superiority of one method over the other, both methods are accepted internationally, and it also is accepted internationally that a country is free to use either method or both. However, it also is recognized internationally—and, as the Committee understands it, was acknowledged by the European Union in the course of the FSC dispute—that the exemption method tends to result in exports being taxed more favorably than comparable domestic transactions.

Turning to the history of the FSC dispute, in 1971, the United States enacted the Domestic International Sales Corporation ("DISC") legislation, which provided a special tax exemption for exports. The European Communities challenged the DISC in the General Agreement on Tariffs and Trade ("GATT"), alleging that it constituted an export subsidy because it resulted in exports being taxed more favorably than comparable domestic transactions. In response, the United States challenged the tax regimes of Belgium, France and the Netherlands, alleging that the use of the exemption method by those countries constituted an export subsidy because it also resulted in exports being taxed more favorably than comparable domestic transactions. In 1976, a GATT panel ruled against the DISC provisions, but also ruled against the European regimes, finding, as a factual matter, that those regimes did tax exports more favorably than comparable domestic transactions.

Following the issuance of the panel rulings, those rulings languished unadopted as the European Communities refused to accept that their regimes provided export subsidies. The European Communities' criticisms of the panel rulings, however, focused on the

panel's legal reasoning, not on the panel's factual findings that the European regimes taxed exports more favorably than comparable domestic transactions. Eventually, the disputes were resolved based on the negotiation of an "Understanding" which was adopted by the GATT Council in 1981. Essentially, this Understanding—elements of which already had been incorporated into the Tokyo Round Subsidies Code—provided that countries did not provide an export subsidy when they refrained from taxing foreign-source income, even if this resulted in exports being taxed more favorably than comparable domestic transactions. The European countries in question interpreted the Understanding as overruling the panel and sanctioning their use of the exemption method. Subsequently, using the principles set forth in the Understanding as a guide, the United States enacted the FSC legislation, the objective being to reap the export-enhancing benefits of the exemption method.

Many years later, the European Union abruptly challenged the FSC provisions in the WTO. Notwithstanding the fact that the FSC provisions were intended to emulate certain elements of a territorial tax system—namely, the use of the exemption method—the Panel and the Appellate Body ruled that the manner in which the United States sought to achieve this objective conflicted with the rules of the WTO Agreement on Subsidies and Countervailing Measures ("SCM Agreement") and the Agreement on Agriculture. However, neither body said that the use of the exemption method itself was an impermissible one, nor did either body rule that a WTO member may not maintain a tax regime that includes features of both worldwide and territorial tax systems. What the Committee is intending to do with this legislation is once again to incorporate elements of a territorial tax system into the U.S. system of worldwide taxation, this time in a manner which does not conflict with WTO rules.

Turning to the actions of the European Union in this dispute, it is the Committee's understanding that this dispute did not arise out of private sector complaints, but instead was initiated by the European Union primarily as a response to its losses in the so-called "bananas" and "beef" disputes. Indeed, it is the Committee's understanding that during the course of this dispute, European Union officials failed, when asked, to provide a single example of actual commercial harm suffered by a European firm as a result of the FSC provisions. In light of this, the Committee finds the European Union's decision to walk away from the 1981 Understanding deeply troubling and provocative as well as threatening to the international trading system.

Notwithstanding these concerns, the United States has moved quickly to comply with the decisions of the Panel and Appellate Body. With the adoption of this legislation, the United States will have met the short deadline set by the Panel under the pressures and constraints of an election year. More significantly, in order to comply with a decision that significantly affects issues of national tax policy, the United States has made fundamental modifications to its tax structure, including features that are common to many European tax systems. The Committee hopes and expects that the European Union will regard this legislation as a faithful and responsible implementation of the WTO rulings in this dispute, un-

derstanding that each WTO member enjoys a sovereign right to decide its own system of taxation within the parameters of its international obligations. The Committee also hopes and expects that the European Union will appreciate the extremely detrimental consequences which a prolongation of this dispute would bring both to our bilateral relations and the successful functioning of the multilateral trading system. The Committee expects the United States to strongly pursue its rights under the WTO, including, as appropriate, the initiation of cases challenging tax systems that exclude certain income from taxation.

The Committee strongly believes that the substantial modification to U.S. tax law provided in this bill is WTO compliant. While the Committee believes it is important for all nations to honor their trade agreements and the obligations those agreements may impart, the Committee also believes it is important that U.S. business interests not be foreclosed from opportunities abroad because of differences in the tax laws in the United States compared to tax laws in other countries. Indeed, the Committee believes that the WTO was not established to conform and restructure tax systems of contracting parties.

Compliance with WTO rulings

In its ruling, the Panel raised the following objections to the FSC provisions of the Code. First, the Panel found that "but for" the existence of the FSC provisions, revenue that otherwise would be fully taxable under the Code enjoyed a lower rate of taxation. Thus, the Panel found the FSC provisions to be a subsidy because partial tax exemptions accorded by the FSC provisions represented, in its view, a forgoing of "government revenue that is otherwise due." Second, the Panel found that the FSC provisions constituted a prohibited export subsidy because only exports receive preferential tax treatment.

The Administration has informed the Committee that the European Union has expressed additional concerns regarding the FSC provisions, even though they were not addressed in the Appellate Body Decision or Panel Decision. Among the European Union's many allegations are that the FSC administrative pricing rules violated the arm's-length pricing provisions of the Subsidies Agreement and that the FSC structure encouraged the use of tax havens.

The Committee believes the approach of H.R. 4986 complies with the Appellate Body and Panel Decisions and modifies the U.S. tax system in a WTO-consistent manner. In addition, the legislation addresses other concerns raised by the European Union that were not decided by the Panel or Appellate Body. The legislation complies with the WTO decisions by repealing the FSC provisions of the Code, thereby eliminating the FSC subsidies issue. Furthermore, the replacement regime achieves WTO-consistency. The legislation responds to both of the determinative findings in the Panel and Appellate Body Decisions—(1) the conclusion that the FSC constitutes a "subsidy," and (2) the conclusion that it constitutes an "export contingent subsidy." The legislation also goes further than the decisions and addresses additional concerns raised by the European Union by eliminating the use of administrative pricing rules

to establish transfer prices and by eliminating the arguable encouragement for the use of tax haven entities.

FSC repeal

The Committee believes that H.R. 4986 complies with the deadline set by the Panel, upheld by the Appellate Body, that "FSC subsidies must be withdrawn at the latest with effect from 1 October 2000." The legislation repeals the FSC provisions thereby eliminating the subsidy at issue in the Panel Decision. By repealing the FSC provisions, the United States has withdrawn what the WTO has found to be a subsidy.

H.R. 4986 confers no "subsidy"

The Panel and Appellate Body ruled that the FSC provisions constitute a "subsidy" because "government revenue that is otherwise due" is forgone. The Appellate Body has acknowledged that a WTO member has the sovereign right to not tax certain categories of income, whether foreign or domestic. Indeed, pure territorial tax systems exclude all foreign source income, including export income, from tax. WTO rules do not compel members to adopt pure territorial tax regimes. Accordingly, the United States, like European Union countries with territorial tax systems (whether pure territorial systems or partial territorial systems) must be free to elect not to tax certain categories of income.

In determining whether revenue forgone is "otherwise due," the Panel, in an analysis upheld by the Appellate Body, examined "the fiscal treatment that would be applicable 'but for' the measures in question."[79] The Appellate Body, in reviewing the Panel Decision, stated that "[t]here must . . . be some defined, normative benchmark against which a comparison can be made between the revenue actually raised and the revenue that would have been raised 'otherwise.'" Thus, the appropriate analysis requires the identification of a prevailing standard of taxation for a particular category of income and a determination of whether this standard is applied consistently to income falling within that category.

The Panel ruled that the FSC provisions excepted certain types of income from the Code's general rule that worldwide income is taxable and, thus, from the taxes that would be due in the absence of the FSC provisions. The Appellate Body, however, confirmed that a WTO member is free to determine how broadly to assert its general taxing authority and "has the sovereign authority to tax any particular categories of revenue it wishes." The Appellate Body Decision also specifically stated that a WTO member is "free not to tax any particular categories of revenues."

H.R. 4986 modifies the general rule of U.S. taxation by fundamentally amending the definition of gross income. Under the Code, the definition of "gross income" defines the outer boundaries of U.S. income taxation. The bill excludes income derived from cer-

[79] The Appellate Body considered the "but for" test a "sound basis for comparison because it is not difficult to establish in what way the foreign-source income of a FSC would be taxed 'but for' the contested measure." However, the Appellate Body cautioned that "we have certain abiding reservations about applying any legal standard, such as this 'but for' test, in the place of the actual treaty language." The Appellate Body observed that the application of a "but for" test is most effective when there is a general rule that applies formally to the revenues in question, absent the contested measures.

tain activities performed outside the United States, referred to as "extraterritorial income," from the definition of gross income and, thus, modifies the extent to which the United States seeks to tax such income. This new general rule thus becomes the normative benchmark for taxing income derived in connection with certain activities performed outside the United States. This general rule applies to foreign trade income, whether the goods are manufactured in the United States or abroad—a substantially broader category of income than that which was exempted from tax under the FSC provisions. The Committee believes that it is important that the activities giving rise to excludable extraterritorial income involve real economic activity, or "economic processes," performed outside the United States. The Committee also believes that it is appropriate to except certain forms of extraterritorial income from the exclusion; however, the Committee emphasizes that the taxation of certain forms of extraterritorial income are exceptions to the general rule of not taxing extraterritorial income.

The Committee emphasizes that, consistent with the Appellate Body Decision, the United States is exercising its sovereign authority not to tax a category of revenue. Because of this substantive change in U.S. income taxation, the exclusion of extraterritorial income becomes the United States' general rule with respect to this category of income. Therefore, the exclusion of such income from taxation does not constitute revenue forgone that is otherwise due and, accordingly, does not give rise to a "subsidy" within the meaning of the WTO rules.

H.R. 4986 does not provide "export-contingent" benefits

In addition to ensuring that the FSC replacement regime is not a "subsidy," the Committee believes that, in order to ensure WTO compatibility, it is important that the new regime not confer export-contingent benefits.[80] To achieve this goal, the Committee has relied on the WTO Appellate Body's interpretation of the meaning of "contingent" for purposes of the Agreement on Subsidies and Countervailing Measures in crafting this legislation.[81] It is the Committee's intent and belief that the exclusion of extraterritorial income from U.S. gross income is not dependent on such income arising from export activities. Accordingly, the Committee has determined that it is appropriate to treat all foreign sales alike, whether the goods were manufactured in the United States or abroad. A taxpayer would receive the same U.S. tax treatment with respect to its foreign sales regardless of whether it exports. As a result, the exclusion for certain extraterritorial income is not "conditional" or "dependent" on whether an entity exports; therefore, it clearly is not export contingent.

[80] Under Article 3.1(a) of the Agreement on Subsidies and Countervailing Measures, subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance, are prohibited. This standard is met when the facts demonstrate that the granting of a subsidy, without having been made legally contingent upon export performance, is in fact tied to actual or anticipated exportation or export earnings. However, the mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy within the meaning of this provision.

[81] See Canada—Measures Affecting the Export of Civilian Aircraft; see also Canada—Certain Measures Affecting the Automotive Industry. In these cases, the WTO Appellate Body has found the term "contingent" to have its ordinary meaning of "conditional" or "dependent for its existence on something else."

The Committee emphasizes that the extraterritorial income excluded by this legislation from the scope of U.S. income taxation is parallel to the foreign-source income excluded from tax under most territorial tax systems. Under neither the U.S. tax system as modified by this legislation nor many European tax systems is the income excluded from taxation limited to income earned through exporting. At the same time, under both systems, exporting is one way to earn foreign source income that is excluded from taxation, and exporters under both systems are among those who can avail themselves of the limitations on the taxing authority of both systems. While exporters may be among those who are eligible for the exclusion, this fact does not make that exclusion "export contingent." If it did, every general exclusion from tax applicable to, among others, exporters would become a prohibited export subsidy.

Addressing other European Union concerns

The Administration has informed the Committee that during the course of the WTO litigation and subsequent consultations with European Union officials, the European Union also raised certain issues relating to the FSC rules that the Panel and Appellate Body did not consider. In this regard, the European Union argued that the administrative pricing rules used to determine the amount of exempt income generated by FSCs were in violation of the arm's-length transfer price provisions in the SCM Agreement. In addition, the European Union alleged that the companies established as FSCs were essentially "sham" corporations and that the FSCs were often located in tax haven countries.

The Committee wants to be clear that because neither the Panel nor the Appellate Body made recommendations with respect to these complaints, the United States is under no obligation to address these issues. Nonetheless, the Committee believes that there is some benefit to be achieved by removing these issues as a source of contention. In addition, the Committee believes that addressing these issues provides an opportunity to simplify the administration of the tax law as well as corporate record keeping.

First, unlike the FSC regime, the bill does not require the use of a separate foreign entity such as the FSC. Therefore, it cannot be argued that the new legislation encourages the formation of "sham" corporations in tax-haven jurisdictions. Second, because there is no separate entity required, there are no transfers required between related domestic and foreign companies. The administrative pricing rules are therefore eliminated as transfer pricing mechanisms. If there are transfers between related parties, general arm's-length principles apply. Further, the Committee notes that the elimination of the need for a separate foreign entity simplifies the administration of the tax law from the perspective of both the IRS and the taxpayer.

Conclusion

The Committee believes that this legislation complies with the WTO decisions and honors U.S. obligations under the WTO. The Committee is of the view that repealing the FSC provisions provides an opportunity to revise the Code in a manner that rationalizes tax treatment for extraterritorial income. The Com-

mittee is confident that, should the bill be challenged in WTO dispute settlement proceedings, the legislation would withstand scrutiny under the trade agreements. The Committee contrasts the timely and thorough action by the United States represented by this legislation with the response of certain foreign nations to findings of other WTO dispute settlement panels in recent cases involving trade in beef and bananas—findings dealing with pure trade issues and not with the fundamental nature of a country's tax regime.

It is the Committee's sincere hope that through this legislation the United States will be able to resolve this dispute.[82]

Report of the Senate Committee on Finance

The Report of the Senate Committee on Finance states:

The Chairman and Ranking Member began a process of reviewing the international provisions of the Code with hearings early in the 106th Congress. Among the issues identified in the testimony was the need to reexamine the U.S. tax treatment of foreign income.

In the interim, a dispute settlement panel of the WTO found that the FSC provisions conferred an export subsidy barred by WTO rules. That decision was affirmed by the WTO Appellate Body.

This legislation addresses both the broader issue of U.S. taxation of income derived from foreign sales, i.e., "extraterritorial income," as well as complying with the WTO rulings. The legislation repeals the FSC provisions of the Code that the Panel and Appellate Body found to be prohibited export subsidies. At the same time, the legislation revises the Code in a manner that rationalizes tax treatment for extraterritorial income.

The legislation modifies the general rule of U.S. taxation by fundamentally amending the definition of gross income. Under the Code, the definition of "gross income" defines the outer boundaries of U.S. income taxation. The bill excludes income derived from certain activities performed outside the United States, referred to as extraterritorial income, from the definition of gross income and, thus, modifies the extent to which the United States seeks to tax such income. This new general rule thus becomes the normative benchmark for taxing income derived in connection with certain activities performed outside the United States.

The Committee believes that, in order to ensure WTO compatibility, it is important that the new regime not confer export-contingent benefits. Accordingly, the Committee has determined that it is appropriate to treat all foreign sales alike. The general exclusion, therefore, applies to foreign trade income, whether the goods are manufactured in the United States or abroad—a substantially broader category of income than that which was exempted from tax under the FSC provisions. A taxpayer would receive the same U.S. tax treatment with respect to its foreign sales regardless of whether it exports.

The Committee notes that the extraterritorial income excluded by this legislation from the scope of U.S. income taxation parallels the foreign-source income excluded under most territorial tax sys-

[82] H. Rep. 106–845, at 12–19 (2000).

tems, particularly those employed by European Union member states. Under neither the U.S. tax system as modified by this legislation nor many European tax systems is the income excluded from taxation limited to income earned through exporting. At the same time, under both systems, exporting is one way to earn foreign source income that is excluded from taxation, and exporters under both systems are among those who can avail themselves of the limitations on the taxing authority of both systems.

The Committee believes that this legislation, which fundamentally changes the U.S. tax treatment of extraterritorial income, complies with the WTO decisions and honors U.S. obligations under the WTO.[83]

Explanation of Provision

Overview

The Act repeals the FSC rules and enacts an exclusion for extraterritorial income. The Act, like the Senate Finance Committee reported version of H.R. 4986, does not include the provision in the House version of H.R. 4986 that provided a dividends-received deduction for certain dividends allocable to qualifying foreign trade income. The Act adopts the compromise language of the conference agreement to H.R. 2614 (“Enactment of Certain Small Business, Health, Tax, and Minimum Wage Provisions”).

Repeal of the FSC rules

The Act repeals the FSC rules found in sections 921 through 927 of the Code.

Exclusion of extraterritorial income

The Act 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.” Because U.S. income tax principles generally deny deductions for expenses related to exempt income, otherwise deductible expenses that are allocated to qualifying foreign trade income generally are disallowed.

The Act applies in the same manner with respect to both individuals and corporations who are U.S. taxpayers. In addition, the exclusion from gross income applies for individual and corporate alternative minimum tax purposes.

Qualifying foreign trade income

Under the Act, 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,[84] (2) 15 percent of the “foreign trade income” derived by the taxpayer

[83] S. Rep. 106–416, at 5 (2000).

[84] The term “transaction” means (1) any sale, exchange, or other disposition; (2) any lease or rental; and (3) any furnishing of services.

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. Notwithstanding the general rule that qualifying foreign trade income is based on one of the three calculations that results in the greatest reduction in taxable income, a taxpayer may choose instead to use one of the other two calculations that does not result in the greatest reduction in taxable 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. Hence, once a taxpayer determines the appropriate reduction of taxable income, that amount must be "grossed up" for related expenses in order to determine the amount of gross income excluded.[85]

If a taxpayer uses 1.2 percent of foreign trading gross receipts to determine the amount of qualifying foreign trade income with respect to a transaction, the taxpayer or any other related persons will be treated as having no qualifying foreign trade income with respect to any other transaction involving the same property.[86] For example, assume that a manufacturer and a distributor of the same product are related persons. The manufacturer sells the product to the distributor at an arm's-length price of $80 (generating $30 of profit) and the distributor sells the product to an unrelated customer outside of the United States for $100 (generating $20 of profit). If the distributor chooses to calculate its qualifying foreign trade income on the basis of 1.2 percent of foreign trading gross receipts, then the manufacturer will be considered to have no qualifying foreign trade income and, thus, would have no excluded income. The distributor's qualifying foreign trade income would be 1.2 percent of $100, and the manufacturer's qualifying foreign trade income would be zero. This limitation is intended to prevent a duplication of exclusions from gross income because the distributor's $100 of gross receipts includes the $80 of gross receipts of the manufacturer. Absent this limitation, $80 of gross receipts would have been double counted for purposes of the exclusion. If both persons were permitted to use 1.2 percent of their foreign trading gross receipts in this example, then the related-person group would have an exclusion based on $180 of foreign trading gross receipts notwithstanding that the related-person group really only generated $100 of gross receipts from the transaction. However, if the distributor chooses to calculate its qualifying foreign trade income on the basis of 15 percent of foreign trade income (15 percent of $20 of profit), then the manufacturer would also be eligible to calculate its qualifying foreign trade income in the same manner (15 percent of $30 of profit).[87] Thus, in the second case, each related person may exclude an amount of income based on their respective

[85] For an example of these calculations, see the General Example, below.

[86] Persons are considered to be related if they are treated as a single employer under section 52(a) or (b) (determined without taking into account section 1563(b), thus including foreign corporations) or section 414(m) or (o).

[87] The manufacturer also could compute qualifying foreign trade income based on 30 percent of foreign sale and leasing income.

profits. The total foreign trade income of the related-person group is $50. Accordingly, allowing each person to calculate the exclusion based on their respective foreign trade income does not result in duplication of exclusions.

Under the Act, a taxpayer may determine the amount of qualifying foreign trade income either on a transaction-by-transaction basis or on an aggregate basis for groups of transactions, so long as the groups are based on product lines or recognized industry or trade usage. Under the grouping method, it is intended that taxpayers be given reasonable flexibility to identify product lines or groups on the basis of recognized industry or trade usage. In general, provided that the taxpayer's grouping is not unreasonable, it will not be rejected merely because the grouped products fall within more than one of the two-digit Standard Industrial Classification codes.[88] The Secretary of the Treasury is granted authority to prescribe rules for grouping transactions in determining qualifying foreign trade income.

Qualifying foreign trade income must be reduced by illegal bribes, kickbacks and similar payments, and by a factor for operations in or related to a country associated in carrying out an international boycott, or participating or cooperating with an international boycott.

In addition, the Act directs the Secretary of the Treasury to prescribe rules for marginal costing in those cases in which a taxpayer is seeking to establish or maintain a market for qualifying foreign trade property.

Foreign trading gross receipts

Under the Act, "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 of 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 of the United States; or (5) for the performance of certain managerial services for unrelated persons. Gross receipts from the lease or rental of qualifying foreign trade property include gross receipts from the license of qualifying foreign trade property. Consistent with the policy adopted in the Taxpayer Relief Act of 1997,[89] this includes the license of computer software for reproduction abroad.

Foreign trading gross receipts do not include gross receipts from a transaction if the qualifying foreign trade property or services are for ultimate use in the United States, or for use by the United States (or an instrumentality thereof) and such use is required by law or regulation. Foreign trading gross receipts also do not include gross receipts from a transaction that is accomplished by a subsidy

[88] By reference to Standard Industrial Classification codes, the provision is intended to include industries as defined in the North American Industrial Classification System.

[89] The Taxpayer Relief Act of 1997, P.L. 105–34.

granted by the government (or any instrumentality thereof) of the country or possession in which the property is manufactured.

A taxpayer may elect to treat gross receipts from a transaction as not foreign trading gross receipts. As a consequence of such an election, the taxpayer could utilize any related foreign tax credits in lieu of the exclusion as a means of avoiding double taxation. It is intended that this election be accomplished by the taxpayer's treatment of such items on its tax return for the taxable year. Provided that the taxpayer's taxable year is still open under the statute of limitations for making claims for refund under section 6511, a taxpayer can make redeterminations as to whether the gross receipts from a transaction constitute foreign trading gross receipts.

Foreign economic processes

Under the Act, gross receipts from a transaction are foreign trading gross receipts only if certain economic processes take place outside of the United States. The foreign economic processes requirement is satisfied if the taxpayer (or any person acting under a contract with the taxpayer) participates outside of the United States in the solicitation (other than advertising), negotiation, or making of the contract relating to such transaction and incurs a specified amount of foreign direct costs attributable to the transaction.[90] For this purpose, foreign direct costs include only those costs incurred in the following categories of activities: (1) advertising and sales promotion; (2) the processing of customer orders and the arranging for delivery; (3) transportation outside of the United States in connection with delivery to the customer; (4) the determination and transmittal of a final invoice or statement of account or the receipt of payment; and (5) the assumption of credit risk. An exception from the foreign economic processes requirement is provided for taxpayers with foreign trading gross receipts for the year of $5 million or less.[91]

The foreign economic processes requirement must be satisfied with respect to each transaction and, if so, any gross receipts from such transaction could be considered as foreign trading gross receipts. For example, all of the lease payments received with respect to a multi-year lease contract, which contract met the foreign economic processes requirement at the time it was entered into, would be considered as foreign trading gross receipts. On the other hand, a sale of property that was formerly a leased asset, which was not sold pursuant to the original lease agreement, generally would be considered a new transaction that must independently satisfy the foreign economic processes requirement.

A taxpayer's foreign economic processes requirement is treated as satisfied with respect to a sales transaction (solely for the purpose of determining whether gross receipts are foreign trading gross receipts) if any related person has satisfied the foreign eco-

[90] The foreign direct costs attributable to the transaction generally must exceed 50 percent of the total direct costs attributable to the transaction, but the requirement also will be satisfied if, with respect to at least two categories of direct costs, the foreign direct costs equal or exceed 85 percent of the total direct costs attributable to each category.

[91] For this purpose, the receipts of related persons are aggregated and, in the case of pass-through entities, the determination of whether the foreign trading gross receipts exceed $5 million is made both at the entity and at the partner/shareholder level.

nomic processes requirement in connection with another sales transaction involving the same qualifying foreign trade property.

Qualifying foreign trade property

Under the Act, 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 ("manufactured") within or outside of the United States that is held primarily for sale, lease, or rental,[92] in the ordinary course of a trade or business, for direct use, consumption, or disposition outside of the United States.[93] 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.[94]

It is understood that under current industry practice, the purchaser of an aircraft contracts separately for the aircraft engine and the airframe, albeit contracting with the airframe manufacturer to attach the separately purchased engine. It is intended that an aircraft engine be qualifying foreign trade property (assuming that all other requirements are satisfied) if (1) it is specifically designed to be separated from the airframe to which it is attached without significant damage to either the engine or the airframe, (2) it is reasonably expected to be separated from the airframe in the ordinary course of business (other than by reason of temporary separation for servicing, maintenance, or repair) before the end of the useful life of either the engine or the airframe, whichever is shorter, and (3) the terms under which the aircraft engine was sold were directly and separately negotiated between the manufacturer of the aircraft engine and the person to whom the aircraft will be ultimately delivered. By articulating this application of the foreign destination test in the case of certain separable aircraft engines, no inference is intended with respect to the application of any destination test under present or prior law or with respect to any other rule of law outside the Act.[95]

The Act excludes certain property from the definition of qualifying foreign trade property. The excluded property is (1) property leased or rented by the taxpayer for use by a related person, (2) certain intangibles,[96] (3) oil and gas (or any primary product thereof), (4) unprocessed softwood timber, (5) certain products the trans-

[92] In addition, consistent with the policy adopted in the Taxpayer Relief Act of 1997, computer software licensed for reproduction is considered as property held primarily for sale, lease, or rental.

[93] "United States" includes Puerto Rico for these purposes because Puerto Rico is included in the customs territory of the United States.

[94] For this purpose, the fair market value of any article imported into the United States is its appraised value as determined under the Tariff Act of 1930. In addition, direct labor costs are determined under the principles of section 263A and do not include costs that would be treated as direct labor costs attributable to "articles," again applying principles of section 263A.

[95] See, e.g., sections 927(a)(1)(B) and 993(c)(1)(B).

[96] The intangibles that are treated as excluded property under the Act are: 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. Computer software that is licensed for reproduction outside of the United States is not excluded from the definition of qualifying foreign trade property.

fer of which are prohibited or curtailed to effectuate the policy set forth in Public Law 96–72, and (6) property designated by Executive order as in short supply. In addition, it is intended that property that is leased or licensed to a related person who is the lessor, licensor, or seller of the same property in a sublease, sublicense, sale, or rental to an unrelated person for the ultimate and predominate use by the unrelated person outside of the United States is not excluded property by reason of such lease or license to a related person.

With respect to property that is manufactured outside of the United States, rules are provided to ensure consistent U.S. tax treatment with respect to manufacturers. The Act requires that property manufactured outside of the United States be manufactured by (1) a domestic corporation, (2) an individual who is a citizen or resident of the United States, (3) a foreign corporation that elects to be subject to U.S. taxation in the same manner as a U.S. corporation, or (4) a partnership or other pass-through entity all of the partners or owners of which are described in (1), (2), or (3) above.[97]

Foreign trade income

Under the Act, "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

Under the Act, "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 (as described above). For example, a distribution company's profit from the sale of qualifying foreign trade property that is associated with sales activities, such as solicitation or negotiation of the sale, advertising, processing customer orders and arranging for delivery, transportation outside of the United States, and other enumerated activities, would constitute foreign sale and leasing income.

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 of the United States. Income from the sale, exchange, or other disposition of qualifying foreign trade property that is or was subject to such a lease[98] (i.e., the sale of the residual interest in the leased property) gives rise to foreign sale and leasing income. Except as provided in regulations, a special limitation applies to leased property that (1) is manufactured by the taxpayer or (2) is acquired by the taxpayer from a related person for a price that was other than arm's length. In such cases, foreign sale and leasing income may

[97] Except as provided by the Secretary of the Treasury, tiered partnerships or pass-through entities will be considered as partnerships or pass-through entities for purposes of this rule if each of the partnerships or entities is directly or indirectly wholly-owned by persons described in (1), (2), or (3) above.

[98] For this purpose, such a lease includes a lease that gave rise to exempt foreign trade income under the FSC provisions.

not exceed the amount of foreign sale and leasing income that would have resulted if the taxpayer had acquired the leased property in a hypothetical arm's-length purchase and then engaged in the actual sale or lease of such property. For example, if a manufacturer leases qualifying foreign trade property that it manufactured, the foreign sale and leasing income derived from that lease may not exceed the amount of foreign sale and leasing income that the manufacturer would have earned with respect to that lease had it purchased the property for an arm's-length price on the day that the manufacturer entered into the lease. For purposes of calculating the limit on foreign sale and leasing income, the manufacturer's basis and, thus, depreciation would be based on this hypothetical arm's-length price. This limitation is intended to prevent foreign sale and leasing income from including profit associated with manufacturing activities.

For purposes of determining foreign sale and leasing income, only directly allocable expenses are taken into account in calculating the amount of foreign trade income. In addition, income properly allocable to certain intangibles is excluded for this purpose.

General example

The following is an example of the calculation of qualifying foreign trade income.

XYZ Corporation, a U.S. corporation, manufactures property that is sold to unrelated customers for use outside of the United States. XYZ Corporation satisfies the foreign economic processes requirement through conducting activities such as solicitation, negotiation, transportation, and other sales-related activities outside of the United States with respect to its transactions. During the year, qualifying foreign trade property was sold for gross proceeds totaling $1,000. The cost of this qualifying foreign trade property was $600. XYZ Corporation incurred $275 of costs that are directly related to the sale and distribution of qualifying foreign trade property. XYZ Corporation paid $40 of income tax to a foreign jurisdiction related to the sale and distribution of the qualifying foreign trade property. XYZ Corporation also generated gross income of $7,600 (gross receipts of $24,000 and cost of goods sold of $16,400) and direct expenses of $4,225 that relate to the manufacture and sale of products other than qualifying foreign trade property. XYZ Corporation also incurred $500 of overhead expenses. XYZ Corporation's financial information for the year is summarized as follows:

	Total	Other property	QFTP [1]
Gross receipts	$25,000.00	$24,000.00	$1,000.00
Cost of goods sold	17,000.00	16,400.00	600.00
Gross income	8,000.00	7,600.00	400.00
Direct expenses ...	4,500.00	4,225.00	275.00
Overhead expenses	500.00		
Net income	3,000.00		

[1] "QFTP" refers to qualifying foreign trade property.

Illustrated below is the computation of the amount of qualifying foreign trade income that is excluded from XYZ Corporation's gross income and the amount of related expenses that are disallowed. In order to calculate qualifying foreign trade income, the amount of foreign trade income first must be determined. Foreign trade income is the taxable income (determined without regard to the exclusion of qualifying foreign trade income) attributable to foreign trading gross receipts. In this example, XYZ Corporation's foreign trading gross receipts equal $1,000. This amount of gross receipts is reduced by the related cost of goods sold, the related direct expenses, and a portion of the overhead expenses in order to arrive at the related taxable income.[99]

Thus, XYZ Corporation's foreign trade income equals $100, calculated as follows:

Foreign trading gross receipts	$1,000.00
Cost of goods sold	600.00
Gross income	400.00
Direct expenses	275.00
Apportioned overhead expenses	25.00
Foreign trade income	100.00

Foreign sale and leasing income is defined as an amount of foreign trade income (calculated taking into account only directly-related expenses) that is properly allocable to certain specified foreign activities. Assume for purposes of this example that of the $125 of foreign trade income ($400 of gross income from the sale of qualifying foreign trade property less only the direct expenses of $275), $35 is properly allocable to such foreign activities (e.g., solicitation, negotiation, advertising, foreign transportation, and other

[99] Overhead expenses must be apportioned in a reasonable manner that does not result in a material distortion of income. In this example, the apportionment of the $500 of overhead expenses on the basis of gross income is assumed not to result in a material distortion of income and is assumed to be a reasonable method of apportionment. Thus, $25 ($500 of total overhead expenses multiplied by 5 percent, i.e., $400 of gross income from the sale of qualifying foreign trade property divided by $8,000 of total gross income) is apportioned to qualifying foreign trading gross receipts. The remaining $475 ($500 of total overhead expenses less the $25 apportioned to qualifying income) is apportioned to XYZ Corporation's other income.

enumerated sales-like activities) and, therefore, is considered to be foreign sale and leasing income.

Qualifying foreign trade income is the amount of *gross income* that, if excluded, will result in a reduction of *taxable income* equal to the greatest of (1) 30 percent of foreign sale and leasing income, (2) 1.2 percent of foreign trading gross receipts, or (3) 15 percent of foreign trade income. Thus, in order to calculate the amount that is excluded from gross income, taxable income must be determined and then "grossed up" for allocable expenses in order to arrive at the appropriate gross income figure. First, for each method of calculating qualifying foreign trade income, the reduction in taxable income is determined. Then, the $275 of direct and $25 of overhead expenses, totaling $300, attributable to foreign trading gross receipts is apportioned to the reduction in taxable income based on the proportion of the reduction in taxable income to foreign trade income. This apportionment is done for each method of calculating qualifying foreign trade income. The sum of the taxable income reduction and the apportioned expenses equals the respective qualifying foreign trade income (i.e., the amount of gross income excluded) under each method, as follows:

	1.2% FTGR [1]	15% FTI [2]	30% FS&LI [3]
Reduction of taxable income:			
1.2% of FTGR (1.2% * $1,000)	12.00		
15% of FTI (15% * $100)		15.00	
30% of FS&LI (30% * $35)			10.50
Gross-up for disallowed expenses:			
$300 * ($12/$100)	36.00		
$300 * ($15/$100)		45.00	
$275 * ($10.50/ $100) [4]			28.88
Qualifying foreign trade income	48.00	60.00	39.38

[1] "FTGR" refers to foreign trading gross receipts.
[2] "FTI" refers to foreign trade income.
[3] "FS&LI" refers to foreign sale and leasing income.
[4] Because foreign sale and leasing income only takes into account direct expenses, it is appropriate to take into account only such expenses for purposes of this calculation.

In the example, the $60 of qualifying foreign trade income is excluded from XYZ Corporation's gross income (determined based on 15 percent of foreign trade income).[100] In connection with excluding $60 of gross income, certain expenses that are allocable to this income are not deductible for U.S. Federal income tax purposes.

[100] Note that XYZ Corporation could choose to use one of the other two methods notwithstanding that they would result in a smaller exclusion.

Thus, $45 ($300 of related expenses multiplied by 15 percent, i.e., $60 of qualifying foreign trade income divided by $400 of gross income from the sale of qualifying foreign trade property) of expenses are disallowed.[101]

	Other property	QFTP	Excluded/ disallowed	Total
Gross receipts ..	$24,000.00	$1,000.00		
Cost of goods sold	16,400.00	600.00		
Gross income ...	7,600.00	400.00	(60.00)	7,940.00
Direct expenses	4,335.00	275.00	(41.25)	4,458.75
Overhead expenses	475.00	25.00	(3.75)	496.25
Taxable Income ...				2,985.00

XYZ Corporation paid $40 of income tax to a foreign jurisdiction related to the sale and distribution of the qualifying foreign trade property. A portion of this $40 of foreign income tax is treated as paid with respect to the qualifying foreign trade income and, therefore, is not creditable for U.S. foreign tax credit purposes. In this case, $6 of such taxes paid ($40 of foreign taxes multiplied by 15 percent, i.e., $60 of qualifying foreign trade income divided by $400 of gross income from the sale of qualifying foreign trade property) is treated as paid with respect to the qualifying foreign trade income and, thus, is not creditable.

The results in this example are the same regardless of whether XYZ Corporation manufactures the property within the United States or outside of the United States through a foreign branch. If XYZ Corporation were an S corporation or limited liability company, the results also would be the same, and the exclusion would pass through to the S corporation owners or limited liability company owners as the case may be.

Other rules

Foreign-source income limitation

The Act provides a limitation with respect to the sourcing of taxable income applicable to certain sale transactions giving rise to foreign trading gross receipts. This limitation only applies with respect to sale transactions involving property that is manufactured within the United States. The special source limitation does not apply when qualifying foreign trade income is determined using 30 percent of the foreign sale and leasing income from the transaction.

This foreign-source income limitation is determined in one of two ways depending on whether the qualifying foreign trade income is

[101] The $300 of allocable expenses includes both the $275 of direct expenses and the $25 of overhead expenses. Thus, the $45 of disallowed expenses represents the sum of $41.25 of direct expenses plus $3.75 of overhead expenses. If qualifying foreign trade income were determined using 30 percent of foreign sale and leasing income, the disallowed expenses would include only the appropriate portion of the direct expenses.

calculated based on 1.2 percent of foreign trading gross receipts or on 15 percent of foreign trade income. If the qualifying foreign trade income is calculated based on 1.2 percent of foreign trading gross receipts, the related amount of foreign-source income may not exceed the amount of foreign trade income that (without taking into account this special foreign-source income limitation) would be treated as foreign-source income if such foreign trade income were reduced by 4 percent of the related foreign trading gross receipts.

For example, assume that foreign trading gross receipts are $2,000 and foreign trade income is $100. Assume also that the taxpayer chooses to determine qualifying foreign trade income based on 1.2 percent of foreign trading gross receipts. Taxable income after taking into account the exclusion of the qualifying foreign trade income and the disallowance of related deductions is $76. Assume that the taxpayer manufactured its qualifying foreign trade property in the United States and that title to such property passed outside of the United States. Absent a special sourcing rule, under section 863(b) (and the regulations thereunder) the $76 of taxable income would be sourced as $38 U.S. source and $38 foreign source. Under the special sourcing rule, the amount of foreign-source income may not exceed the amount of the foreign trade income that otherwise would be treated as foreign source if the foreign trade income were reduced by 4 percent of the related foreign trading gross receipts. Reducing foreign trade income by 4 percent of the foreign trading gross receipts (4 percent of $2,000, or $80) would result in $20 ($100 foreign trade income less $80). Applying section 863(b) to the $20 of reduced foreign trade income would result in $10 of foreign-source income and $10 of U.S.-source income. Accordingly, the limitation equals $10. Thus, although under the general sourcing rule $38 of the $76 taxable income would be treated as foreign source, the special sourcing rule limits foreign-source income in this example to $10 (with the remaining $66 being treated as U.S.-source income).

If the qualifying foreign trade income is calculated based on 15 percent of foreign trade income, the amount of related foreign-source income may not exceed 50 percent of the foreign trade income that (without taking into account this special foreign-source income limitation) would be treated as foreign-source income.

For example, assume that foreign trade income is $100 and the taxpayer chooses to determine its qualifying foreign trade income based on 15 percent of foreign trade income. Taxable income after taking into account the exclusion of the qualifying foreign trade income and the disallowance of related deductions is $85. Assume that the taxpayer manufactured its qualifying foreign trade property in the United States and that title to such property passed outside of the United States. Absent a special sourcing rule, under section 863(b) the $85 of taxable income would be sourced as $42.50 U.S. source and $42.50 foreign source. Under the special sourcing rule, the amount of foreign-source income may not exceed 50 percent of the foreign trade income that otherwise would be treated as foreign source. Applying section 863(b) to the $100 of foreign trade income would result in $50 of foreign-source income and $50 of U.S.-source income. Accordingly, the limitation equals $25, which is 50 percent of the $50 foreign-source income. Thus, al-

though under the general sourcing rule $42.50 of the $85 taxable income would be treated as foreign source, the special sourcing rule limits foreign-source income in this example to $25 (with the remaining $60 being treated as U.S.-source income).[102]

Treatment of withholding taxes

The Act generally provides that no foreign tax credit is allowed for foreign taxes paid or accrued with respect to qualifying foreign trade income (i.e., excluded extraterritorial income). In determining whether foreign taxes are paid or accrued with respect to qualifying foreign trade income, foreign withholding taxes generally are treated as not paid or accrued with respect to qualifying foreign trade income.[103] Accordingly, the Act's denial of foreign tax credits would not apply to such taxes. For this purpose, the term "withholding tax" refers to any foreign tax that is imposed on a basis other than residence and that is otherwise a creditable foreign tax under sections 901 or 903.[104] It is intended that such taxes would be similar in nature to the gross-basis taxes described in sections 871 and 881.

If, however, qualifying foreign trade income is determined based on 30 percent of foreign sale and leasing income, the special rule for withholding taxes is not applicable. Thus, in such cases foreign withholding taxes may be treated as paid or accrued with respect to qualifying foreign trade income and, accordingly, are not creditable under the Act.

Election to be treated as a U.S. corporation

The Act provides that certain foreign corporations may elect, on an original return, to be treated as domestic corporations. The election applies to the taxable year when made and all subsequent taxable years unless revoked by the taxpayer or terminated for failure to qualify for the election. Such election is available for a foreign corporation (1) that manufactures property in the ordinary course of such corporation's trade or business, or (2) if substantially all of the gross receipts of such corporation are foreign trading gross receipts. For this purpose, "substantially all" is based on the relevant facts and circumstances.

In order to be eligible to make this election, the foreign corporation must waive all benefits granted to such corporation by the United States pursuant to a treaty.[105] Absent such a waiver, it would be unclear, for example, whether the permanent establishment article of a relevant tax treaty would override the electing corporation's treatment as a domestic corporation under this provision. A foreign corporation that elects to be treated as a domestic corporation is not permitted to make an S corporation election. The

[102] The foreign-source income limitation provisions also apply when source is determined solely in accordance with section 862 (e.g., a distributor of qualifying foreign trade property that is manufactured in the United States by an unrelated person and sold for use outside of the United States).

[103] With respect to the withholding taxes that are paid or accrued (a prerequisite to the taxes being otherwise creditable), the provision in the Act treats such taxes as not being paid or accrued with respect to qualifying foreign trade income.

[104] This also would apply to any withholding tax that is creditable for U.S. foreign tax credit purposes under an applicable treaty.

[105] The waiver of treaty benefits applies to the corporation itself and not, for example, to employees of or independent contractors associated with the corporation.

Secretary is granted authority to prescribe rules to ensure that the electing foreign corporation pays its U.S. income tax liabilities and to designate one or more classes of corporations that may not make such an election.[106] If such an election is made, for purposes of section 367 the foreign corporation is 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.

If a corporation fails to meet the applicable requirements, described above, for making the election to be treated as a domestic corporation for any taxable year beginning after the year of the election, the election will terminate. In addition, a taxpayer, at its option and at any time, may revoke the election to be treated as a domestic corporation. In the case of either a termination or a revocation, the electing foreign corporation will not be considered as a domestic corporation effective beginning on the first day of the taxable year following the year of such termination or revocation. For purposes of section 367, if the election to be treated as a domestic corporation is terminated or revoked, such corporation is treated as a domestic corporation transferring (as of the first day of the first taxable year to which the election ceases to apply) all of its property to a foreign corporation in connection with an exchange to which section 354 applies. Moreover, once a termination occurs or a revocation is made, the former electing corporation may not again elect to be taxed as a domestic corporation under the provisions of the Act for a period of five tax years beginning with the first taxable year that begins after the termination or revocation.

For example, assume a U.S. corporation owns 100 percent of a foreign corporation. The foreign corporation manufactures outside of the United States and sells what would be qualifying foreign trade property were it manufactured by a person subject to U.S. taxation. Such foreign corporation could make the election under this provision to be treated as a domestic corporation. As a result, its earnings no longer would be deferred from U.S. taxation. However, by electing to be subject to U.S. taxation, a portion of its income would be qualifying foreign trade income.[107] The requirement that the foreign corporation be treated as a domestic corporation (and, therefore, subject to U.S. taxation) is intended to provide parity between U.S. corporations that manufacture abroad in branch form and U.S. corporations that manufacture abroad through foreign subsidiaries. The election, however, is not limited to U.S.-owned foreign corporations. A foreign-owned foreign corporation that wishes to qualify for the treatment provided under the Act could avail itself of such election (unless otherwise precluded from doing so by Treasury regulations).

Shared partnerships

The Act provides rules relating to allocations of qualifying foreign trade income by certain shared partnerships. To the extent that such a partnership (1) maintains a separate account for trans-

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[106] For example, the Secretary of the Treasury may prescribe rules to prevent "per se" corporations under the entity-classification rules from making such an election.

[107] The sourcing limitation described above would not apply to this example because the property is manufactured outside of the United States.

actions involving foreign trading gross receipts with each partner, (2) makes distributions to each partner based on the amounts in the separate account, and (3) meets such other requirements as the Treasury Secretary may prescribe by regulations, such partnership then would allocate to each partner items of income, gain, loss, and deduction (including qualifying foreign trade income) from such transactions on the basis of the separate accounts. It is intended that with respect to, and only with respect to, such allocations and distributions (i.e., allocations and distributions related to transactions between the partner and the shared partnership generating foreign trading gross receipts), these rules would apply in lieu of the otherwise applicable partnership allocation rules such as those in section 704(b). For this purpose, a partnership is a foreign or domestic entity that is considered to be a partnership for U.S. Federal income tax purposes.

Under the Act, any partner's interest in the shared partnership is not taken into account in determining whether such partner is a "related person" with respect to any other partner for purposes of the Act's provisions. Also, the election to exclude certain gross receipts from foreign trading gross receipts must be made separately by each partner with respect to any transaction for which the shared partnership maintains a separate account.

Certain assets not taken into account for purposes of interest expense allocation

The Act also provides that qualifying foreign trade property that is held for lease or rental, in the ordinary course of a trade or business, for use by the lessee outside of the United States is not taken into account for interest allocation purposes.

Distributions of qualifying foreign trade income by cooperatives

Agricultural and horticultural producers often market their products through cooperatives, which are member-owned corporations formed under Subchapter T of the Code. At the cooperative level, the Act provides the same treatment of foreign trading gross receipts derived from products marketed through cooperatives as it provides for foreign trading gross receipts of other taxpayers. That is, the qualifying foreign trade income attributable to those foreign trading gross receipts is excluded from the gross income of the cooperative. Absent a special rule, however, patronage dividends or per-unit retain allocations attributable to qualifying foreign trade income paid to members of cooperatives would be taxable in the hands of those members. It is believed that this would disadvantage agricultural and horticultural producers who choose to market their products through cooperatives relative to those individuals who market their products directly or through pass-through entities such as partnerships, limited liability companies, or S corporations. Accordingly, the Act provides that the amount of any patronage dividends or per-unit retain allocations paid to a member of an agricultural or horticultural cooperative (to which Part I of Subchapter T applies), which is allocable to qualifying foreign trade income of the cooperative, is treated as qualifying foreign trade income of the member (and, thus, excludable from such member's

gross income). In order to qualify, such amount must be designated by the organization as allocable to qualifying foreign trade income in a written notice mailed to its patrons not later than the payment period described in section 1382(d). The cooperative cannot reduce its income (e.g., cannot claim a "dividends-paid deduction") under section 1382 for such amounts.

Gap period before administrative guidance is issued

It is recognized that there may be a gap in time between the enactment of the Act and the issuance of detailed administrative guidance. It is intended that during this gap period before administrative guidance is issued, taxpayers and the Internal Revenue Service may apply the principles of prior-law regulations and other administrative guidance under sections 921 through 927 to analogous concepts under the Act. Some examples of the application of the principles of prior-law regulations to the Act are described below. These limited examples are intended to be merely illustrative and are not intended to imply any limitation regarding the application of the principles of other analogous rules or concepts under prior law.

Marginal costing and grouping

Under the Act, the Secretary of the Treasury is provided authority to prescribe rules for using marginal costing and for grouping transactions in determining qualifying foreign trade income. It is intended that similar principles under prior-law regulations apply for these purposes.[108]

Excluded property

The Act provides that qualifying foreign trade property does not include property leased or rented by the taxpayer for use by a related person. It is intended that similar principles under prior-law regulations apply for this purpose. Thus, excluded property does not apply, for example, 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 and the property is ultimately used by such unrelated person predominantly outside of the United States.[109] In addition, consistent with the policy adopted in the Taxpayer Relief Act of 1997, computer software that is licensed for reproduction outside of the United States is not excluded property. Accordingly, the license of computer software to a related person for reproduction outside of the United States for sale, sublicense, lease, or rental to an unrelated person for use outside of the United States is not treated as excluded property by reason of the license to the related person.

[108] See, e.g., Treas. Reg. sec. 1.924(d)–1(c)(5) and (e); Temp. Treas. Reg. sec. 1.925(a)–1T(c)(8); Temp. Treas. Reg. sec. 1.925(b)–1T.

[109] See Temp. Treas. Reg. sec. 1.927(a)–1T(f)(2)(i). The Act also provides that oil or gas or primary products from oil or gas are excluded from the definition of qualifying foreign trade property. It is intended that similar principles under prior-law regulations apply for these purposes. Thus, for this purpose, petrochemicals, medicinal products, insecticides, and alcohols are not considered primary products from oil or gas and, thus, are not treated as excluded property. See Temp. Treas. Reg. sec. 1.927(a)–1T(g)(2)(iv).

Foreign trading gross receipts

Under the Act, foreign trading gross receipts are gross receipts from, among other things, the sale, exchange, or other disposition of qualifying foreign trade property, and from the lease of qualifying foreign trade property for use by the lessee outside of the United States. It is intended that the principles of prior-law regulations that define foreign trading gross receipts apply for this purpose. For example, a sale includes an exchange or other disposition and a lease includes a rental or sublease and a license or a sublicense.[110]

Foreign use requirement

Under the Act, property constitutes qualifying foreign trade property if, among other things, the property is held primarily for lease, sale, or rental, in the ordinary course of business, for direct use, consumption, or disposition outside of the United States.[111] It is intended that the principles of the prior-law regulations apply for purposes of this foreign use requirement. For example, for purposes of determining whether property is sold for use outside of the United States, property that is sold to an unrelated person as a component to be incorporated into a second product which is produced, manufactured, or assembled outside of the United States will not be considered to be used in the United States (even if the second product ultimately is used in the United States), provided that the fair market value of such seller's components at the time of delivery to the purchaser constitutes less than 20 percent of the fair market value of the second product into which the components are incorporated (determined at the time of completion of the production, manufacture, or assembly of the second product).[112]

In addition, for purposes of the foreign use requirement, property is considered to be used by a purchaser or lessee outside of the United States during a taxable year if it is used predominantly outside of the United States.[113] For this purpose, property is considered to be used predominantly outside of the United States for any period if, during that period, the property is located outside of the United States more than 50 percent of the time.[114] An aircraft or other property used for transportation purposes (e.g., railroad rolling stock, a vessel, a motor vehicle, or a container) is considered to be used outside of the United States for any period if, for the period, either the property is located outside of the United States more than 50 percent of the time or more than 50 percent of the miles traveled in the use of the property are traveled outside of the United States.[115] An orbiting satellite is considered to be located outside of the United States for these purposes.[116]

[110] See Temp. Treas. Reg. sec. 1.924(a)–1T(a)(2).
[111] Foreign trading gross receipts eligible for exclusion from the tax base do not include gross receipts from a transaction if the qualifying foreign trade property is for ultimate use in the United States.
[112] See Temp. Treas. Reg. sec. 1.927(a)–1T(d)(4)(ii).
[113] See Temp. Treas. Reg. sec. 1.927(a)–1T(d)(4)(iii), (iv), and (v).
[114] See Temp. Treas. Reg. sec. 1.927(a)–1T(d)(4)(vi).
[115] Id.
[116] Id.

Foreign economic processes

Under the Act, gross receipts from a transaction are foreign trading gross receipts eligible for exclusion from the tax base only if certain economic processes take place outside of the United States. The foreign economic processes requirement compares foreign direct costs to total direct costs. It is intended that the principles of the prior-law regulations apply during the gap period for purposes of the foreign economic processes requirement including the measurement of direct costs. It is recognized that the measurement of foreign direct costs under the prior-law regulations often depend on activities conducted by the FSC, which is a separate entity. It is recognized that some of these concepts will have to be modified when new guidance is promulgated as a result of the Act's elimination of the requirement for a separate entity.

Effective Date

In general

The Act is effective for transactions entered into after September 30, 2000. In addition, no corporation may elect to be a FSC after September 30, 2000.

The Act also provides a rule requiring the termination of a dormant FSC when the FSC has been inactive for a specified period of time. Under this rule, a FSC that generates no foreign trade income for any five consecutive years beginning after December 31, 2001, will cease to be treated as a FSC.

Transition rules

Winding down existing FSCs and binding contract relief

The Act provides a transition period for existing FSCs and for binding contractual agreements. The new rules do not apply to transactions in the ordinary course of business [117] involving a FSC before January 1, 2002. Furthermore, the new rules do not apply to transactions in the ordinary course of business after December 31, 2001, if such transactions are pursuant to a binding contract between a FSC (or a person related to the FSC on September 30, 2000) and any other person (that is not a related person) and such contract is in effect on September 30, 2000, and all times thereafter. For this purpose, binding contracts include purchase options, renewal options, and replacement options that are enforceable against a lessor or seller (provided that the options are a part of a contract that is binding and in effect on September 30, 2000).

Old earnings and profits of corporations electing to be treated as domestic corporations

A transition rule also is provided for certain corporations electing to be treated as a domestic corporation under the Act. In the case of a corporation to which this transition rule applies, the corporation's earnings and profits accumulated in taxable years ending before October 1, 2000 are not included in the gross income of the shareholder by reason of the deemed asset transfer for section 367

[117] The mere entering into of a single transaction, such as a lease, would not, in and of itself, prevent the transaction from being in the ordinary course of business.

purposes that the Act provides. Thus, although the electing corporation may be treated as transferring all of its assets to a domestic corporation in a reorganization described in section 368(a)(1)(F), the earnings and profits amount that would otherwise be treated as a deemed dividend to the U.S. shareholder under the regulations under section 367(b) will not include the earnings and profits accumulated in taxable years ending before October 1, 2000. This treatment is similar to the treatment of earnings and profits of a foreign insurance company that makes the election to be treated as a domestic corporation under section 953(d), which election was a model for the election to be treated as a domestic corporation under the Act. Under section 953(d), earnings and profits accumulated in taxable years beginning before January 1, 1988 were not included in the earnings and profits amount that would be a deemed dividend for section 367(b) purposes.

Like the pre-1988 earnings and profits of a domesticating foreign insurance company under section 953(d), the earnings and profits to which this transition rule applies would continue to be treated as earnings and profits of a foreign corporation even after the corporation elects to be treated as a domestic corporation. Thus, a distribution out of earnings and profits of an electing corporation accumulated in taxable years ending before October 1, 2000 would be treated as a distribution made by a foreign corporation.[118] Rules similar to those applicable to corporations making the section 953(d) election that prevent the repatriation of pre-election period earnings and profits without current U.S. taxation apply for this purpose. Thus, for example, the earnings and profits accumulated in taxable years beginning before October 1, 2000 would continue to be taken into account for section 1248 purposes.[119]

The earnings and profits to which the transition rule applies are the earnings and profits accumulated by the electing corporation in taxable years ending before October 1, 2000. The transition rule will not apply to earnings and profits accumulated before that date that are succeeded to after that date by the electing corporation in a transaction to which section 381 applies unless, like the electing corporation, the distributor or transferor (from whom the electing corporation acquired the earnings and profits) could have itself made the election under the Act to be treated as a domestic corporation and would have been eligible for the transition relief.

The transition rule for old earnings and profits applies to two classes of taxpayers. The first class is FSCs in existence on September 30, 2000 that make an election to be treated as a domestic corporation because they satisfy the requirement that substantially all of their gross receipts are foreign trading gross receipts. To be eligible for the transition relief, the election must be made not later than for the FSC's first taxable year beginning after December 31, 2001.

The second class of corporations to which this transition relief applies is certain controlled foreign corporations (as defined in section 957). Notwithstanding other requirements for making the elec-

[118] It is anticipated that ordering rules similar to those that have been applied in guidance under section 953(d) would apply to distributions from the electing corporation. See Notice 89–79, 1989–2 C.B. 392.

[119] See the rules of section 953(d)(4)(ii), (iii) and (iv).

tion to be treated as a domestic corporation provided under the Act's general provisions, such controlled foreign corporations are eligible under the transition rule to make the election to be treated as a domestic corporation and will not have the resulting deemed asset transfer cause a deemed inclusion of earnings and profits for earnings and profits accumulated in taxable years ending before October 1, 2000. To be eligible for the transition relief, such a controlled foreign corporation must be in existence on September 30, 2000. The controlled foreign corporation must be wholly owned, directly or indirectly, by a domestic corporation.[120] The controlled foreign corporation must never have made an election to be treated as a FSC and must make the election to be treated as a domestic corporation not later than for its first taxable year beginning after December 31, 2001. In addition, the controlled foreign corporation must satisfy certain tests with respect to its income and activities. For administrative convenience, these tests are limited to the three taxable years preceding the first taxable year for which the election to be treated as a domestic corporation applies. First, during that three-year period, all of the controlled foreign corporation's gross income must be subpart F income. Thus, the income was subject to full inclusion to the U.S. shareholder and, accordingly, subject to current U.S. taxation. Second, during that three-year period, the controlled foreign corporation must have, in the ordinary course of its trade or business, entered into transactions in which it regularly sold or paid commissions to a related FSC (which also was in existence on September 30, 2000).[121] If an electing corporation in this second class ceases to be (directly or indirectly) wholly owned by the domestic corporation that owns it on September 30, 2000, the election to be treated as a domestic corporation is terminated.

Limitation on use of the gross receipts method

Similar to the limitation on use of the gross receipts method under the Act's operative provisions, the Act provides a rule that limits the use of the gross receipts method for transactions after the effective date of the Act if that same property generated foreign trade income to a FSC using the gross receipts method. Under the rule, if any person used the gross receipts method under the FSC regime, neither that person nor any related person will have qualifying foreign trade income with respect to any other transaction involving the same item of property.

Coordination of new regime with prior law

Notwithstanding the transition period, FSCs (or related persons) may elect to have the rules of the Act apply in lieu of the rules applicable to FSCs. Thus, for transactions to which the transition rules apply (i.e., transactions after September 30, 2000 that occur

[120] The ultimate owner must be an actual domestic corporation, not a corporation that elects to be treated as a domestic corporation under the Act. In addition, although the controlled foreign corporation must be wholly owned for this purpose, it is intended that the mere nominal ownership of an insignificant number of shares of insignificant value (which may, for example, be required by foreign law) by someone unrelated to the domestic parent would not cause the controlled foreign corporation to fail to be wholly owned for these purposes.

[121] It is intended that, if the controlled foreign corporation's and related FSC's taxable years are still open under the statute of limitations for claims for refund under section 6511, redeterminations with respect to sales or commissions paid to the FSC are permitted for this purpose. See Temp. Treas. Reg. sec. 1.925(a)–1T(d)(4).

(1) before January 1, 2002 or (2) after December 31, 2001 pursuant to a binding contract which is in effect on September 30, 2000), taxpayers may choose to apply either the FSC rules or the amendments made by this Act, but not both. In addition, a taxpayer would not be able to avail itself of the rules of the Act in addition to the rules applicable to domestic international sales corporations because the Act provides that the exclusion of extraterritorial income will not apply if a taxpayer is a member of any controlled group of which a domestic international sales corporation is a member.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $153 million in 2001, $315 million in 2002, $348 million in 2003, $384 million in 2004, $423 million in 2005, $466 million in 2006, $514 million in 2007, $566 million in 2008, $623 million in 2009, and $687 million in 2010.

PART EIGHT: THE COMMUNITY RENEWAL TAX RELIEF ACT OF 2000 (PUBLIC LAW 106–554; H.R. 5662) [122]

TITLE I. COMMUNITY RENEWAL PROVISIONS [123]

A. Renewal Community Provisions (secs. 101–102 of H.R. 5662 and secs. 51, 469, and new secs. 1400E–J of the Code)

Present and Prior Law

In recent years, provisions have been added to the Code that target specific geographic areas for special Federal income tax treatment. For example, empowerment zones and enterprise communities generally provide tax incentives for businesses that locate within certain geographic areas designated by the Secretaries of Housing and Urban Development ("HUD") and Agriculture.

Explanation of Provision

The provision authorizes the designation of 40 "renewal communities" within which special tax incentives will be available. The following is a description of the designation process and the tax incentives that will be available within the renewal communities.

Designation process

Designation of 40 renewal communities.—The Secretary of HUD,[124] is authorized to designate up to 40 renewal communities from areas nominated by States and local governments. At least 12 of the designated communities must be in rural areas.

The Secretary of HUD is required to publish (within four months after enactment) regulations describing the nomination and selection process. Designations of renewal communities are to be made during the period beginning on the first day of the first month after the regulations are published and ending on December 31, 2001. The designation of an area as a renewal community generally will be effective on January 1, 2002, and will terminate after December 31, 2009.[125]

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[122] For legislative background, see H.R. 4577, "Making Omnibus Consolidated and Emergency Supplemental Appropriations for Fiscal Year 2001" (H. Rep. 106–1033, Dec. 15, 2000). H.R. 5662 was incorporated by reference into H.R. 4577.

[123] For legislative background of these provisions, see H. Rep. 106–1033 (Dec. 15, 2000), at 977–1000, and H. Rep. 106–1004 (Oct. 26, 2000) that accompanied H.R. 2614, at 330–353. The conference report to H.R. 2614 was passed by the House of Representatives on October 26, 2000, but was not brought to a vote in the Senate.

[124] In making the designations, the Secretary of HUD must consult with the Secretaries of Agriculture, Commerce, Labor, Treasury, the Director of the Office of Management and Budget; and the Administrator of the Small Business Administration (and the Secretary of the Interior in the case of an area within an Indian reservation).

[125] The designation would terminate earlier than December 31, 2009, if (1) an earlier termination date is designated by the State or local government in their designation, or (2) the Secretary of HUD revokes the designation as of an earlier date.

Eligibility criteria.—To be designated as a renewal community, a nominated area must meet the following criteria: (1) each census tract must have a poverty rate of at least 20 percent;[126] (2) in the case of an urban area, at least 70 percent of the households have incomes below 80 percent of the median income of households within the local government jurisdiction; (3) the unemployment rate is at least 1.5 times the national unemployment rate; and (4) the area is one of pervasive poverty, unemployment, and general distress. Those areas with the highest average ranking of eligibility factors (1), (2), and (3) above will be designated as renewal communities. The Secretary of HUD shall take into account in selecting areas for designation the extent to which such areas have a high incidence of crime, as well as whether the area has census tracts identified in the May 12, 1998, report of the GAO regarding the identification of economically distressed areas. In lieu of the poverty, income, and unemployment criteria, outmigration may be taken into account in the designation of one rural renewal community.

There are no geographic size limitations placed on renewal communities. Instead, the boundary of a renewal community must be continuous. In addition, the renewal community must have a minimum population of 4,000 if the community is located within a metropolitan statistical area (at least 1,000 in all other cases), and a maximum population of not more than 200,000. The population limitations do not apply to any renewal community that is entirely within an Indian reservation.

Required State and local commitments.—In order for an area to be designated as a renewal community, State and local governments are required to submit a written course of action in which the State and local governments promise to take at least four of the following governmental actions within the nominated area: (1) a reduction of tax rates or fees; (2) an increase in the level of efficiency of local services; (3) crime reduction strategies; (4) actions to remove or streamline governmental requirements; (5) involvement by private entities and community groups, such as to provide jobs and job training and financial assistance; and (6) the gift (or sale at below fair market value) of surplus realty by the State or local government to community organizations or private companies.

In addition, the nominating State and local governments must promise to promote economic growth in the nominated area by repealing or not enforcing four of the following: (1) licensing requirements for occupations that do not ordinarily require a professional degree; (2) zoning restrictions on home-based businesses that do not create a public nuisance; (3) permit requirements for street vendors who do not create a public nuisance; (4) zoning or other restrictions that impede the formation of schools or child care centers; and (5) franchises or other restrictions on competition for businesses providing public services, including but not limited to taxicabs, jitneys, cable television, or trash hauling, unless such regulations are necessary for and well-tailored to the protection of health and safety.

Empowerment zones and enterprise communities seeking designation as renewal communities.—With respect to the first 20 designa-

[126] Determined using 1990 census data.

tions of nominated areas as renewal communities, preference will be given to nominated areas that are enterprise communities and empowerment zones under present law that otherwise meet the requirements for designation as a renewal community. An empowerment zone or enterprise community can apply for designation as a renewal community. If a renewal community designation is granted, then an area's designation as an empowerment zone or enterprise community ceases as of the date the area's designation as a renewal community takes effect.

Tax incentives for renewal communities

The following tax incentives generally are available during the period beginning January 1, 2002, and ending December 31, 2009.[127]

Zero-percent capital gain rate.—A zero-percent capital gains rate applies with respect to gain from the sale of a qualified community asset acquired after December 31, 2001, and before January 1, 2010, and held for more than five years. A "qualified community asset" includes: (1) qualified community stock (meaning original-issue stock purchased for cash in a renewal community business); (2) a qualified community partnership interest (meaning a partnership interest acquired for cash in a renewal community business); and (3) qualified community business property (meaning tangible property originally used in a renewal community business by the taxpayer) that is purchased or substantially improved after December 31, 2001.

A "renewal community business" is similar to the present-law definition of an enterprise zone business.[128] Property will continue to be a qualified community asset if sold (or otherwise transferred) to a subsequent purchaser, provided that the property continues to represent an interest in (or tangible property used in) a renewal community business. The termination of an area's status as a renewal community will not affect whether property is a qualified community asset, but any gain attributable to the period before January 1, 2002, or after December 31, 2014, is not eligible for the zero-percent rate.

Renewal community employment credit.—A 15-percent wage credit is available to employers for the first $10,000 of qualified wages paid to each employee who (1) is a resident of the renewal community, and (2) performs substantially all employment services within the renewal community in a trade or business of the employer.

The wage credit rate applies to qualifying wages paid after December 31, 2001, and before January 1, 2010. Wages that qualify for the credit are wages that are considered "qualified zone wages" for purposes of the empowerment zone wage credit (including coordination with the Work Opportunity Tax Credit). In general, any taxable business carrying out activities in the renewal community may claim the wage credit.

Commercial revitalization deduction.—Each State is permitted to allocate up to $12 million of "commercial revitalization expenditures" to each renewal community located within the State for each

[127] If a renewal community designation is terminated prior to December 31, 2009, the tax incentives would cease to be available as of the termination date.

[128] An "enterprise zone business" is defined in section 1397B.

calendar year after 2001 and before 2010. The appropriate State agency will make the allocations pursuant to a qualified allocation plan.

A "commercial revitalization expenditure" means the cost of a new building or the cost of substantially rehabilitating an existing building. The building must be used for commercial purposes and be located in a renewal community. In the case of the rehabilitation of an existing building, the cost of acquiring the building will be treated as qualifying expenditures only to the extent that such costs do not exceed 30 percent of the other rehabilitation expenditures. The qualifying expenditures for any building cannot exceed $10 million.

A taxpayer can elect either to (a) deduct one-half of the commercial revitalization expenditures for the taxable year the building is placed in service or (b) amortize all the expenditures ratably over the 120–month period beginning with the month the building is placed in service. No depreciation is allowed for amounts deducted under this provision. The adjusted basis is reduced by the amount of the commercial revitalization deduction, and the deduction is treated as a depreciation deduction in applying the depreciation recapture rules (e.g., sec. 1250).

The commercial revitalization deduction is treated in the same manner as the low-income housing credit in applying the passive loss rules (sec. 469). Thus, up to $25,000 of deductions (together with the other deductions and credits not subject to the passive loss limitation by reason of section 469(i)) are allowed to an individual taxpayer regardless of the taxpayer's adjusted gross income. The commercial revitalization deduction is allowed in computing a taxpayer's alternative minimum taxable income.

Additional section 179 expensing.—A renewal community business is allowed an additional $35,000 of section 179 expensing for qualified renewal property placed in service after December 31, 2001, and before January 1, 2010. The section 179 expensing allowed to a taxpayer is phased out by the amount by which 50 percent of the cost of qualified renewal property placed in service during the year by the taxpayer exceeds $200,000. The term "qualified renewal property" is similar to the definition of "qualified zone property" used in connection with empowerment zones.

Extension of work opportunity tax credit ("WOTC").—The provision expands the high-risk youth and qualified summer youth categories in the WOTC to include qualified individuals who live in a renewal community.

GAO Report.—The GAO will audit and report to Congress on January 31, 2004, and again in 2007 and 2010, on the renewal community program and its effect on poverty, unemployment, and economic growth within the renewal communities.

Effective Date

Renewal communities must be designated during the period beginning on the first day of the first month after the publication of regulations by HUD and ending on December 31, 2001. The tax benefits available in renewal communities are effective for the period beginning January 1, 2002, and ending December 31, 2009.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $364 million in 2002, $591 million in 2003, $564 million in 2004, $579 million in 2005, $624 million in 2006, $701 million in 2007, $910 million in 2008, $950 million in 2009, and $369 million in 2010.

B. Empowerment Zone Tax Incentives

1. Extension and expansion of empowerment zones (secs. 111–115 of H.R. 5662 and secs. 1391, 1394, 1396, and 1397A of the Code)

Present and Prior Law

Round I empowerment zones

The Omnibus Budget Reconciliation Act of 1993 ("OBRA 1993") authorized the designation of nine empowerment zones ("Round I empowerment zones") to provide tax incentives for businesses to locate within targeted areas designated by the Secretaries of HUD and Agriculture. The Taxpayer Relief Act of 1997 ("1997 Act") authorized the designation of two additional Round I urban empowerment zones.

Businesses in the 11 Round I empowerment zones qualify for the following tax incentives: (1) a 20-percent wage credit for the first $15,000 of wages paid to a zone resident who works in the empowerment zone,[129] (2) an additional $20,000 of section 179 expensing for qualifying zone property, and (3) tax-exempt financing for certain qualifying zone facilities. Under prior law, the tax incentives with respect to the empowerment zones designated by OBRA 1993 generally were available during the 10-year period of 1995 through 2004. The incentives with respect to the two additional Round I empowerment zones generally were available during the 10-year period of 2000 through 2009.[130]

Round II empowerment zones

The 1997 Act also authorized the designation of 20 additional empowerment zones ("Round II empowerment zones"), of which 15 are located in urban areas and five are located in rural areas. Businesses in the Round II empowerment zones were not eligible for the wage credit, but were eligible to receive up to $20,000 of additional section 179 expensing. Businesses in the Round II empowerment zones also were eligible for more generous tax-exempt financing benefits than those available in the Round I empowerment zones. Specifically, the tax-exempt financing benefits for the Round II empowerment zones are not subject to the State private activity bond volume caps (but are subject to separate per-zone volume limitations), and the per-business size limitations that apply to the

[129] For wages paid in calendar years during the period 1994 through 2001, the credit rate is 20 percent. The credit rate is reduced to 15 percent for calendar year 2002, 10 percent for calendar year 2003, and 5 percent for calendar year 2004. No wage credit is available after 2004 in the original nine empowerment zones.

[130] Except for the wage credit, which is reduced to 15 percent for calendar year 2005, and then reduced by five percentage points in each year in 2006 and 2007, with no wage credit available after 2007.

Round I empowerment zones and enterprise communities (i.e., $3 million for each qualified enterprise zone business with a maximum of $20 million for each principal user for all zones and communities) do not apply to qualifying bonds issued for Round II empowerment zones. Under prior law, the tax incentives with respect to the Round II empowerment zones generally were available during the 10-year period of 1999 through 2008.

Explanation of Provision

The provision conforms and enhances the tax incentives for the Round I and Round II empowerment zones and extends their designations through December 31, 2009. The provision also authorizes the designation of nine new empowerment zones ("Round III empowerment zones").

Extension of tax incentives for Round I and Round II empowerment zones

The designation of empowerment zone status for the Round I and II empowerment zones (other than the D.C. Enterprise Zone) is extended through December 31, 2009. In addition, the 20-percent wage credit is made available in all Round I and II empowerment zones for qualifying wages paid or incurred after December 31, 2001. The credit rate remains at 20 percent (rather than being phased down) through December 31, 2009, in Round I and Round II empowerment zones.

In addition, $35,000 (rather than $20,000) of additional section 179 expensing is available for qualified zone property placed in service in taxable years beginning after December 31, 2001, by a qualified business in any of the empowerment zones.[131] Businesses in the D.C. Enterprise Zone are entitled to the additional section 179 expensing until the termination of the D.C. Enterprise zone designation.

Businesses located in Round I empowerment zones (other than the D.C. Enterprise Zone)[132] also are eligible for the more generous tax-exempt bond rules that apply under present law to businesses in the Round II empowerment zones (sec. 1394(f)). The provision applies to tax-exempt bonds issued after December 31, 2001. Bonds that have been issued by businesses in Round I empowerment zones before January 1, 2002, are not taken into account in applying the limitations on the amount of new empowerment zone facility bonds that can be issued under the provision.

Nine new empowerment zones

The Secretaries of HUD and Agriculture are authorized to designate nine additional empowerment zones ("Round III empowerment zones"). Seven of the Round III empowerment zones will be located in urban areas, and two will be located in rural areas. In addition, a replacement empowerment zone may be designated for each empowerment zone that becomes a renewal community. The

[131] The additional $35,000 of section 179 expensing is available throughout all areas that are part of a designated empowerment zone, including the non-contiguous "developable sites" that were allowed to be part of the designated Round II empowerment zones under the 1997 Act.

[132] The present-law rules of sections 1394 and 1400A continue to apply with respect to the D.C. Enterprise Zone.

replacement empowerment zone will have the same urban or rural character as the empowerment zone that it is replacing.

The eligibility and selection criteria for the Round III empowerment zones are the same as the criteria that applied to the Round II empowerment zones. The Round III empowerment zones must be designated by January 1, 2002, and the tax incentives with respect to the Round III empowerment zones generally are available during the period beginning on January 1, 2002, and ending on December 31, 2009.

Businesses in the Round III empowerment zones are eligible for the same tax incentives that, under the provision, are available to the Round I and Round II empowerment zones (i.e., a 20-percent wage credit, an additional $35,000 of section 179 expensing, and the enhanced tax-exempt financing benefits presently available to Round II empowerment zones).

GAO report

The GAO will audit and report to Congress on January 31, 2004, and again in 2007 and 2010, on the empowerment zone and enterprise community program and its effect on poverty, unemployment, and economic growth within the designated areas.

Effective Date

The extension of the existing empowerment zone designations is effective after the date of enactment (December 21, 2000). The extension of the tax benefits to existing empowerment zones (i.e., the expanded wage credit, the additional section 179 expensing, and the more generous tax-exempt bond rules) generally is effective after December 31, 2001. The new Round III empowerment zones must be designated by January 1, 2002, and the tax incentives with respect to the Round III empowerment zones generally are available during the period beginning on January 1, 2002, and ending on December 31, 2009.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $243 million in 2002, $470 million in 2003, $470 million in 2004, $537 million in 2005, $592 million in 2006, $599 million in 2007, $615 million in 2008, $783 million in 2009, and $239 million in 2010.

2. Rollover of gain from the sale of qualified empowerment zone investments (sec. 116 of H.R. 5662 and new sec. 1397B of the Code)

Present and Prior Law

In general, gain or loss is recognized on any sale, exchange, or other disposition of property. A taxpayer (other than a corporation) may elect to roll over without payment of tax any capital gain realized upon the sale of qualified small business stock held for more than six months where the taxpayer uses the proceeds to purchase other qualified small business stock within 60 days of the sale of the original stock (sec. 1045).

Explanation of Provision

Under the provision, a taxpayer can elect to roll over capital gain from the sale or exchange of any qualified empowerment zone asset purchased after the date of enactment and held for more than one year ("original zone asset") where the taxpayer uses the proceeds to purchase other qualifying empowerment zone assets in the same zone ("replacement zone asset") within 60 days of the sale of the original zone asset. The holding period of the replacement zone asset includes the holding period of the original zone asset, except that the replacement asset must actually be held for more than one year to qualify for another tax-free rollover. The basis of the replacement zone asset is reduced by the gain not recognized on the rollover. However, if the replacement zone asset is qualified small business stock (as defined in sec. 1202), the exclusion under section 1202 will not apply to gain accrued on the original zone asset.[133] A "qualified empowerment zone asset" means an asset that would be a qualified community asset if the empowerment zone were a renewal community (and the asset is acquired after date of enactment (December 21, 2000)).[134] Assets in the D.C. Enterprise Zone are not eligible for the tax-free rollover treatment.[135]

Effective Date

The provision is effective for qualifying assets purchased after the date of enactment (December 21, 2000).

Revenue Effect

This provision (together with the provision increasing the exclusion of gain from the sale of qualifying empowerment zone stock) is estimated to reduce Federal fiscal year budget receipts by less than $500,000 in 2001, $3 million in 2002, $15 million in 2003, $32 million in 2004, $52 million in 2005, $71 million in 2006, $93 million in 2007, $118 million in 2008, $152 million in 2009, and $202 million in 2010.

3. Increased exclusion of gain from the sale of qualifying empowerment zone stock (sec. 117 of H.R. 5662 and sec. 1202 of the Code)

Present and Prior Law

An individual, subject to limitations, may exclude 50 percent of the gain from the sale of qualifying small business stock held more than five years (sec. 1202). Under prior law, there was no distinction with respect to stock of a qualified empowerment zone business.

[133] See section 1045 for rollover of qualified small business stock to other small business stock.

[134] A "qualified community asset" (as defined in sec. 1400F(b)) includes: (1) qualified community stock, (2) a qualified community partnership interest, and (3) qualified community business property.

[135] However, a qualifying D.C. Zone asset held for more than five years is eligible for a zero-percent capital gains rate (sec. 1400B).

Explanation of Provision

The provision increases the exclusion for small business stock to 60 percent for stock purchased after the date of enactment in a corporation that is a qualified business entity and that is held for more than five years. A "qualified business entity" means a corporation that satisfies the requirements of a qualifying business under the empowerment zone rules during substantially all the taxpayer's holding period.

Effective Date

The provision is effective for qualified stock purchased after the date of enactment (December 21, 2000).

Revenue Effect

This provision (together with the provision permitting the rollover of gain from the sale of qualified empowerment zone investments) is estimated to reduce Federal fiscal year budget receipts by less than $500,000 in 2001, $3 million in 2002, $15 million in 2003, $32 million in 2004, $52 million in 2005, $71 million in 2006, $93 million in 2007, $118 million in 2008, $152 million in 2009, and $202 million in 2010.

C. New Markets Tax Credit (sec. 121 of H.R. 5662 and new sec. 45D of the Code)

Present and Prior Law

Tax incentives are available to taxpayers making investments and loans in low-income communities. For example, tax incentives are available to taxpayers that invest in specialized small business investment companies licensed by the Small Business Administration to make loans to, or equity investments in, small businesses owned by persons who are socially or economically disadvantaged.

Explanation of Provision

The provision creates a new tax credit for qualified equity investments made to acquire stock or a partnership interest in a selected community development entity ("CDE"). The maximum annual amount of qualifying equity investments is capped as follows:

Calendar year	Maximum qualifying equity investment
2001	$1.0 billion
2002–2003	$1.5 billion per year
2004–2005	$2.0 billion per year
2006–2007	$3.5 billion per year

The amount of the new tax credit to the investor (either the original purchaser or a subsequent holder) is (1) a five-percent credit for the year in which the equity interest is purchased from the CDE and the first two anniversary dates after the interest is purchased from the CDE, and (2) a six percent credit on each anni-

versary date thereafter for the following four years.[136] The taxpayer's basis in the investment is reduced by the amount of the credit (other than for purposes of calculating the capital gain exclusion under sections 1202, 1400B, and 1400F). The credit is subject to the general business credit rules.

A CDE is any domestic corporation or partnership (1) whose primary mission is serving or providing investment capital for low-income communities or low-income persons, (2) that maintains accountability to residents of low-income communities by their representation on any governing board or on any advisory board of the CDE, and (3) is certified by the Treasury Department as an eligible CDE.[137] No later than 120 days after enactment, the Treasury Department shall issue guidance that specifies objective criteria to be used by the Treasury Department to allocate the credits among eligible CDEs. In allocating the credits, the Treasury Department will give priority to entities with records of having successfully provided capital or technical assistance to disadvantaged businesses or communities,[138] as well as to entities that intend to invest substantially all of the proceeds from their investors in businesses in which persons unrelated to the CDE hold the majority of the equity interest.

If a CDE fails to sell equity interests to investors up to the amount authorized within five years of the authorization, then the remaining authorization is canceled. The Treasury Department can authorize another CDE to issue equity interests for the unused portion. No authorization can be made after 2014.

A "qualified equity investment" is defined as stock or a similar equity interest acquired directly from a CDE in exchange for cash. Substantially all of the investment proceeds must be used by the CDE to make "qualified low-income community investments." Qualified low-income community investments include: (1) capital or equity investments in, or loans to, qualified active businesses located in low-income communities,[139] (2) certain financial counseling and other services specified in regulations to businesses and residents in low-income communities, (3) the purchase from another CDE of any loan made by such entity that is a qualified low income community investment, and (4) an equity investment in, or loans to, another CDE.[140] Treasury Department regulations will provide guidance with respect to the "substantially all" standard.

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[136] Thus, a credit would be available on the date on which the investment is made and for each of the six anniversary dates thereafter.

[137] A specialized small business investment company and a community development financial institution are treated as satisfying the requirements for a CDE.

[138] A record of having successfully provided capital or technical assistance to disadvantaged businesses or communities could be demonstrated by the past actions of the CDE itself or an affiliate (e.g., in the case where a new CDE is established by a nonprofit organization with a history of providing assistance to disadvantaged communities).

[139] Thus, a qualified low-income community investment may include an investment in a qualifying business in which the CDE (or a related party) holds a significant interest. However, as previously mentioned, in allocating the credits among eligible CDEs, the Treasury Department will give priority to CDEs that intend to invest substantially all of the proceeds from their investors in businesses in which persons unrelated to the CDE hold the majority of the equity interest. Persons are related to each other if they are described in sections 267(b) or 707(b)(1).

[140] If at least 85 percent of the aggregate gross assets of the CDE are invested (directly or indirectly) in equity interests in, or loans to, qualified active businesses located in low-income communities, then there would be no need to trace the use of the proceeds from the particular stock (or other equity ownership) issuance with respect to which the credit is claimed.

If an entity fails to be a CDE during the seven-year period following the taxpayer's investment, or if the equity interest is redeemed by the issuing CDE during that seven-year period, then any credits claimed with respect to the equity interest are recaptured (with interest) and no further credits are allowed.

A "low-income community" is defined as census tracts with either (1) poverty rates of at least 20 percent (based on the most recent census data), or (2) median family income which does not exceed 80 percent of the greater of metropolitan area income or statewide median family income (for a non-metropolitan census tract, 80 percent of non-metropolitan statewide median family income). In addition, the Secretary may designate any area within any census tract as a "low income community" provided that (1) the boundary of the area is continuous,[141] (2) the area (if it were a census tract) would satisfy the poverty rate or median income requirements within the targeted area, and (3) an inadequate access to investment capital exists in the area. A low-income community may include an area located within a possession of the United States.[142]

A "qualified active business" is defined as a business which satisfies the following requirements: (1) at least 50 percent of the total gross income of the business is derived from the active conduct of trade or business activities in low-income communities; (2) a substantial portion of the use of the tangible property of such business is used in low-income communities; (3) a substantial portion of the services performed for such business by its employees is performed in low-income communities; and (4) less than 5 percent of the average aggregate of unadjusted bases of the property of such business is attributable to certain financial property or to collectibles (other than collectibles held for sale to customers). There is no requirement that employees of the business be residents of the low-income community.

Rental of improved commercial real estate located in a low-income community is a qualified active business, regardless of the characteristics of the commercial tenants of the property. The purchase and holding of unimproved real estate is not a qualified active business. In addition, a qualified active business does not include (a) any business consisting predominantly of the development or holding of intangibles for sale or license; or (b) operation of any facility described in sec. 144(c)(6)(B). A qualified active business can include an organization that is organized on a non-profit basis.

The General Accounting Office will audit and report to Congress by January 31, 2004, and again in 2007 and 2010, on the new markets tax credit program, including on all qualified community development entities that receive an allocation under the new markets tax credit program.

Effective Date

The provision is effective for qualified investments made after December 31, 2000.

[141] It is intended that the continuous boundary that delineates the portion of the census tract as a "low-income community" should be a pre-existing boundary (such as an established neighborhood, political, or geographic boundary).

[142] For this purpose, a U.S. possession means Puerto Rico, the Virgin Islands, Guam, the Northern Mariana Islands, and American Samoa.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $2 million in 2001, $18 million in 2002, $115 million in 2003, $246 million in 2004, $365 million in 2005, $531 million in 2006, $725 million in 2007, $813 million in 2008, $828 million in 2009, and $747 million in 2010.

D. Increase the Low-Income Housing Tax Credit Cap and Make Other Modifications (secs. 131–137 of H.R. 5662 and sec. 42 of the Code)

Present and Prior Law

In general

The low-income housing tax credit may be claimed over a 10-year period for the cost of rental housing occupied by tenants having incomes below specified levels. The credit percentage for newly constructed or substantially rehabilitated housing that is not Federally subsidized is adjusted monthly by the Internal Revenue Service so that the 10 annual installments have a present value of 70 percent of the total qualified expenditures. The credit percentage for new substantially rehabilitated housing that is Federally subsidized and for existing housing that is substantially rehabilitated is calculated to have a present value of 30 percent qualified expenditures.

Credit cap

The aggregate credit authority provided annually to each State is $1.25 per resident, except in the case of projects that also receive financing with proceeds of tax-exempt bonds issued subject to the private activity bond volume limit and certain carry-over amounts.

Expenditure test

Generally, the building must be placed in service in the year in which it receives an allocation to qualify for the credit. An exception is provided in the case where the taxpayer has expended an amount equal to 10-percent or more of the taxpayer's reasonably expected basis in the building by the end of the calendar year in which the allocation is received and certain other requirements are met.

Basis of building eligible for the credit

Buildings receiving assistance under the HOME investment partnerships act ("HOME") are not eligible for the enhanced credit for buildings located in high cost areas (i.e., qualified census tracts and difficult development areas). Under the enhanced credit, the 70-percent and 30-percent credit is increased to a 91-percent and 39-percent credit, respectively.

Eligible basis is generally limited to the portion of the building used by qualified low-income tenants for residential living and some common areas.

State allocation plans

Each State must develop a plan for allocating credits and such plan must include certain allocation criteria including: (1) project

location; (2) housing needs characteristics; (3) project characteristics; (4) sponsor characteristics; (5) participation of local tax-exempts; (6) tenant populations with special needs; and (7) public housing waiting lists. The State allocation plan must also give preference to housing projects: (1) that serve the lowest income tenants; and (2) that are obligated to serve qualified tenants for the longest periods.

Credit administration

There are no explicit requirements that housing credit agencies perform a comprehensive market study of the housing needs of the low-income individuals in the area to be served by the project, nor that such agency conduct site visits to monitor for compliance with habitability standards.

Stacking rule

Authority to allocate credits remains at the State (as opposed to local) government level unless State law provides otherwise.[143] Generally, credits may be allocated only from volume authority arising during the calendar year in which the building is placed in service, except in the case of: (1) credits claimed on additions to qualified basis; (2) credits allocated in a later year pursuant to an earlier binding commitment made no later than the year in which the building is placed in service; and (3) carryover allocations.

Each State annually receives low-income housing credit authority equal to $1.25 per State resident for allocation to qualified low-income projects.[144] In addition to this $1.25 per resident amount, each State's "housing credit ceiling" includes the following amounts: (1) the unused State housing credit ceiling (if any) of such State for the preceding calendar year;[145] (2) the amount of the State housing credit ceiling (if any) returned in the calendar year;[146] and (3) the amount of the national pool (if any) allocated to such State by the Treasury Department.

The national pool consists of States' unused housing credit carryovers. For each State, the unused housing credit carryover for a calendar year consists of the excess (if any) of the unused State housing credit ceiling for such year over the excess (if any) of the aggregate housing credit dollar amount allocated for such year over the sum of $1.25 per resident and the credit returns for such year. The amounts in the national pool are allocated only to a State, which allocated its entire housing credit ceiling for the preceding calendar year, and requested a share in the national pool not later than May 1 of the calendar year. The national pool allocation to qualified States is made on a pro rata basis equivalent to the frac-

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[143] For example, constitutional home rule cities in Illinois are guaranteed their proportionate share of the $1.25 amount, based on their population relative to that of the State as a whole.

[144] A State's population, for these purposes, is the most recent estimate of the State's population released by the Bureau of the Census before the beginning of the year to which the limitation applies. Also, for these purposes, the District of Columbia and the U.S. possessions (i.e., Puerto Rico, the Virgin Islands, Guam, the Northern Marianas and American Samoa) are treated as States.

[145] The unused State housing credit ceiling is the amount (if positive) of the previous year's annual credit limitation plus credit returns less the credit actually allocated in that year.

[146] Credit returns are the sum of any amounts allocated to projects within a State that fails to become a qualified low-income housing project within the allowable time period plus any amounts allocated to a project within a State under an allocation, which is canceled by mutual consent of the housing credit agency and the allocation recipient.

tion that a State's population enjoys relative to the total population of all qualified States for that year.

The present-law stacking rule provides that a State is treated as using its annual allocation of credit authority ($1.25 per State resident) and any returns during the calendar year followed by any unused credits carried forward from the preceding year's credit ceiling and finally any applicable allocations from the National pool.

Explanation of Provision

Credit cap

H.R. 5662 increases the per-capita low-income housing credit cap from $1.25 per capita to $1.50 per capita in calendar year 2001 and to $1.75 per capita in calendar year 2002. Beginning in calendar year 2003, the per-capita portion of the credit cap will be adjusted annually for inflation. For small States, a minimum annual cap of $2 million is provided for calendar years 2001 and 2002. Beginning in calendar year 2003, the small State minimum is adjusted for inflation.

Expenditure test

H.R. 5662 allows a building which receives an allocation in the second half of a calendar to qualify under the 10-percent test if the taxpayer expends an amount equal to 10-percent or more of the taxpayer's reasonably expected basis in the building within six months of receiving the allocation regardless of whether the 10-percent test is met by the end of the calendar year.

Basis of building eligible for the credit

H.R. 5662 makes three changes to the basis rules of the credit. First, the definition of qualified census tracts for purposes of the enhanced credit is expanded to include any census tracts with a poverty rate of 25 percent or more. Second, H.R. 5662 extends the credit to a portion of the building used as a community service facility not in excess of 10 percent of the total eligible basis in the building. A community service facility is defined as any facility designed to serve primarily individuals whose income's are 60 percent or less of area median income. Third, H.R. 5662 provides that assistance received under the Native American Housing Assistance and Self-Determination Act of 1996 is not taken into account in determining whether a building is Federally subsidized for purposes of the credit. This allows such buildings to qualify for something other than the 30-percent credit generally applicable to Federally subsidized buildings.

State allocation plans

H.R. 5662 strikes the plan criteria relating to participation of local tax-exempts, replacing it with two other criteria: tenant populations of individuals with children and projects intended for eventual tenant ownership. It also provides that the present-law criteria relating to sponsor characteristics include whether the project involves the use of existing housing as part of a community revitalization plan. H.R. 5662 adds a third category of housing projects

to the preferential list, projects located in qualified census tracts, which contribute to a concerted community revitalization plan.

Credit administration

H.R. 5662 requires a comprehensive market study of the housing needs of low-income individuals in the area to be served by the project and a written explanation, available to the general public, for any allocation not made in accordance with the established priorities and selection criteria of the housing credit agency. It also requires site inspections by the housing credit agency to monitor compliance with habitability standards applicable to the project.

Stacking rule

H.R. 5662 modifies the stacking rule so that each State is treated as using its allocation of the unused State housing credit ceiling (if any) from the preceding calendar before the current year's allocation of credit (including any credits returned to the State) and then finally any National pool allocations.

Effective Date

The provision is generally effective for calendar years beginning after December 31, 2000, and buildings placed-in-service after such date in the case of projects that also receive financing with proceeds of tax-exempt bonds subject to the private activity bond volume limit which are issued after such date.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $9 million in 2001, $52 million in 2002, $148 million in 2003, $282 million in 2004, $433 million in 2005, $598 million in 2006, $779 million in 2007, $976 million in 2008, $1,188 million in 2009, and $1,416 million in 2010.

E. Accelerate Scheduled Increase in State Volume Limits on Tax-Exempt Private Activity Bonds (sec. 161 of H.R. 5662 and sec. 146 of the Code)

Present and Prior Law

Interest on bonds issued by States and local governments is excluded from income if the proceeds of the bonds are used to finance activities conducted and paid for by the governmental units (sec. 103). Interest on bonds issued by these governmental units to finance activities carried out and paid for by private persons ("private activity bonds") is taxable unless the activities are specified in the Internal Revenue Code. Private activity bonds on which interest may be tax-exempt include bonds for privately operated transportation facilities (airports, docks and wharves, mass transit, and high speed rail facilities), privately owned and/or provided municipal services (water, sewer, solid waste disposal, and certain electric and heating facilities), economic development (small manufacturing facilities and redevelopment in economically depressed areas), and certain social programs (low-income rental housing,

qualified mortgage bonds, student loan bonds, and exempt activities of charitable organizations described in sec. 501(c)(3)).

The volume of tax-exempt private activity bonds that States and local governments may issue for most of these purposes in each calendar year is limited by statewide volume limits. The current annual volume limits are $50 per resident of the State or $150 million if greater. The volume limits do not apply to private activity bonds to finance airports, docks and wharves, certain governmentally owned, but privately operated, solid waste disposal facilities, certain high speed rail facilities, and to certain types of private activity tax-exempt bonds that are subject to other limits on their volume (qualified veterans' mortgage bonds and certain "new" empowerment zone and enterprise community bonds).

The current annual volume limits that apply to private activity tax-exempt bonds increase to $75 per resident of each State or $225 million, if greater, beginning in calendar year 2007. The increase is, ratably phased in, beginning with $55 per capita or $165 million, if greater, in calendar year 2003.

Explanation of Provision

H.R. 5662 increases the State volume limits from the greater of $50 per resident or $150 million to the greater of $62.50 per resident or $187.5 million in calendar year 2001. The volume limits will increase further, to the greater of $75 per resident or $225 million in calendar year 2002. Beginning in calendar year 2003, the volume limits will be adjusted annually for inflation.

Effective Date

The provision is effective beginning in calendar year 2001.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $16 million in 2001, $95 million in 2002, $195 million in 2003, $284 million in 2004, $361 million in 2005, $425 million in 2006, $473 million in 2007, $513 million in 2008, $557 million in 2009, and $600 million in 2010.

F. Extension and Modification to Expensing of Environmental Remediation Costs (sec. 162 of H.R. 5662 and sec. 198 of the Code)

Present and Prior Law

Taxpayers can elect to treat certain environmental remediation expenditures that would otherwise be chargeable to capital account as deductible in the year paid or incurred (sec. 198). The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site.

A "qualified contaminated site" generally is any property that (1) is held for use in a trade or business, for the production of income, or as inventory; (2) is certified by the appropriate State environmental agency to be located within a targeted area; and (3) con-

tains (or potentially contains) a hazardous substance (so-called "brownfields"). Targeted areas are defined as: (1) empowerment zones and enterprise communities as designated under present law; (2) sites announced before February 1997, as being subject to one of the 76 Environmental Protection Agency ("EPA") Brownfields Pilots; (3) any population census tract with a poverty rate of 20 percent or more; and (4) certain industrial and commercial areas that are adjacent to tracts described in (3) above. However, sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 cannot qualify as targeted areas.

Eligible expenditures are those paid or incurred before January 1, 2002.

Explanation of Provision

The provision extends the expiration date for eligible expenditures to include those paid or incurred before January 1, 2004.

In addition, the provision eliminates the targeted area requirement, thereby, expanding eligible sites to include any site containing (or potentially containing) a hazardous substance that is certified by the appropriate State environmental agency. However, expenditures undertaken at sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 would continue to not qualify as eligible expenditures.

By extending and expanding section 198, the Congress does not intend to displace the general tax law principle regarding expensing versus capitalization of expenditures which continues to apply to environmental remediation efforts not specifically covered under section 198.

Effective Date

The provision to extend the expiration date is effective upon the date of enactment (December 21, 2000). The provision to expand the class of eligible sites is effective for expenditures paid or incurred after the date of enactment.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $13 million in 2001, $97 million in 2002, $225 million in 2003, $165 million in 2004, $39 million in 2005, $1 million in 2006, and to increase Federal fiscal year receipts by $5 million in 2007, $17 million in 2008, $17 million in 2009, and $12 million in 2010.

G. Expansion of District of Columbia Homebuyer Tax Credit (sec. 163 of H.R. 5662 and sec. 1400C of the Code)

Present and Prior Law

First-time homebuyers of a principal residence in the District of Columbia are eligible for a nonrefundable tax credit of up to $5,000 of the amount of the purchase price. The $5,000 maximum credit applies both to individuals and married couples. Married individ-

uals filing separately can claim a maximum credit of $2,500 each. The credit phases out for individual taxpayers with adjusted gross income between $70,000 and $90,000 ($110,000–$130,000 for joint filers). For purposes of eligibility, "first-time homebuyer" means any individual if such individual did not have a present ownership interest in a principal residence in the District of Columbia in the one year period ending on the date of the purchase of the residence to which the credit applies. Under prior law, the credit was scheduled to expire for residences purchased after December 31, 2001.[147]

Explanation of Provision

The provision extends the first-time homebuyer credit for two years (through December 31, 2003).

Effective Date

The provision is effective on the date of enactment (December 21, 2000).

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by less than $500,000 in 2001, and to reduce Federal fiscal year budget receipts by $7 million in 2002, and $25 million in 2003, $14 million in 2004, and by less than $500,000 in each of the years 2005 through 2010.

H. Extension of D.C. Enterprise Zone (sec. 164 of H.R. 5662 and secs. 1400, 1400A and 1400B of the Code)

Present and Prior Law

The Taxpayer Relief Act of 1997 designated certain economically depressed census tracts within the District of Columbia as the District of Columbia Enterprise Zone (the "D.C. Zone"), within which businesses and individual residents are eligible for special tax incentives. Under prior law, the D.C. Zone designation remained in effect for the period from January 1, 1998, through December 31, 2002. In addition to the tax incentives generally available with respect to empowerment zones, the D.C. Zone also has a zero-percent capital gains rate that applies to gain from the sale of certain qualified D.C. Zone assets acquired after December 31, 1997 and held for more than five years.

With respect to the tax-exempt financing incentives, the D.C. Zone generally is treated like a Round I empowerment zone; therefore, the issuance of such bonds is subject to the District of Columbia's annual private activity bond volume limitation. However, the aggregate face amount of all outstanding qualified enterprise zone facility bonds per qualified D.C. Zone business may not exceed $15 million (rather than $3 million, as is the case for Round I empowerment zones).

[147] As previously discussed, section 510 of the Tax Relief Extension Act of 1999 extended the provision for one year (through December 31, 2001).

Explanation of Provision

The provision extends the D.C. Zone designation for one year (through December 31, 2003). The present-law rules of sections 1394 and 1400A continue to apply with respect to the D.C. Enterprise Zone.

Effective Date

The provision is effective on the date of enactment (December 21, 2000).

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $42 million in 2003, $26 million in 2004, $15 million in 2005, $15 million in 2006, $16 million in 2007, $19 million in 2008, $34 million in 2009, and $36 million in 2010.

I. Extension and Modification of Enhanced Deduction for Corporate Donations of Computer Technology (sec. 165 of H.R. 5662 and sec. 170(e)(6) of the Code)

Present and Prior Law

The maximum charitable contribution deduction that may be claimed by a corporation for any one taxable year is limited to 10 percent of the corporation's taxable income for that year (disregarding charitable contributions and with certain other modifications) (sec. 170(b)(2)). Corporations also are subject to certain limitations based on the type of property contributed. In the case of a charitable contribution of short-term gain property, inventory, or other ordinary income property, the amount of the deduction generally is limited to the taxpayer's basis (generally, cost) in the property. However, special rules in the Code provide an augmented deduction for certain corporate contributions. Under these special rules, the amount of the augmented deduction is equal to the lesser of (1) the basis of the donated property plus one-half of the amount of ordinary income that would have been realized if the property had been sold, or (2) twice the basis of the donated property.

Section 170(e)(6) allows corporate taxpayers an augmented deduction for qualified contributions of computer technology and equipment (i.e., computer software, computer or peripheral equipment, and fiber optic cable related to computer use) to be used within the United States for educational purposes in grades K–12. Eligible donees are: (1) any educational organization that normally maintains a regular faculty and curriculum and has a regularly enrolled body of pupils in attendance at the place where its educational activities are regularly carried on; and (2) tax-exempt charitable organizations that are organized primarily for purposes of supporting elementary and secondary education. A private foundation also is an eligible donee, provided that, within 30 days after receipt of the contribution, the private foundation contributes the property to an eligible donee described above.

Qualified contributions are limited to gifts made no later than two years after the date the taxpayer acquired or substantially

completed the construction of the donated property. In addition, the original use of the donated property must commence with the donor or the donee. Accordingly, qualified contributions generally are limited to property that is no more than two years old. Such donated property could be computer technology or equipment that is inventory or depreciable trade or business property in the hands of the donor.

Donee organizations are not permitted to transfer the donated property for money or services (e.g., a donee organization cannot sell the computers). However, a donee organization may transfer the donated property in furtherance of its exempt purposes and be reimbursed for shipping, installation, and transfer costs. For example, if a corporation contributes computers to a charity that subsequently distributes the computers to several elementary schools in a given area, the charity could be reimbursed by the elementary schools for shipping, transfer, and installation costs.

The special treatment applies only to donations made by C corporations. S corporations, personal holding companies, and service organizations are not eligible donors.

The provision is scheduled to expire for contributions made in taxable years beginning after December 31, 2000.

Explanation of Provision

The provision extends the enhanced deduction for donations of computer technology and equipment through December 31, 2003, expands the enhanced deduction to include donations to public libraries, and expands the class of qualifying property.

Qualifying donations include gifts made no later than three years after the date the taxpayer acquired or substantially completed the construction of the donated property. In addition, the provision provides that contributions may be made by a person that has reacquired the property (i.e., if a computer manufacturer reacquires the computer from the original user and then contributes it). Such reacquired property must be contributed within three years of the date the original construction of the property was substantially completed. The Congress anticipates that for purposes of computing the enhanced deduction for a reacquirer, the Secretary will provide guidance in determining the retail value of donated computers (or other technology) in situations in which the number of actual retail sales of used computers similar to those donated is small in relation to the number of such computers that are donated.

The provision also provides that the Secretary may prescribe by regulation standards to ensure that the donations meet minimum functionality and suitability standards for educational purposes.

Effective Date

The provision is effective for contributions made after December 31, 2000.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $63 million in 2001, $118 million in 2002, $126 million in 2003, $63 million in 2004, and $3 million in 2005.

J. Treatment of Indian Tribes as Non-Profit Organizations and State or Local Governments for Purposes of the Federal Unemployment Tax ("FUTA") (sec. 166 of H.R. 5662 and sec. 3306 of the Code)

Present and Prior Law

Present law imposes a net tax on employers equal to 0.8 percent of the first $7,000 paid annually to each employee. The current gross FUTA tax is 6.2 percent, but employers in States meeting certain requirements and having no delinquent loans are eligible for a 5.4 percent credit making the net Federal tax rate 0.8 percent. Both non-profit organizations and State and local governments are not required to pay FUTA taxes. Instead they may elect to reimburse the unemployment compensation system for unemployment compensation benefits actually paid to their former employees. Generally, Indian tribes are not eligible for the reimbursement treatment allowable to non-profit organizations and State and local governments.

Explanation of Provision

H.R. 5662 provides that an Indian tribe (in including any subdivision, subsidiary, or business enterprise chartered and wholly owned by an Indian tribe) is treated like a non-profit organization or State or local government for FUTA purposes (i.e., given an election to choose the reimbursement treatment).

Effective Date

The provision generally is effective with respect to service performed beginning on or after the date of enactment (December 21, 2000). Under a transition rule, service performed in the employ of an Indian tribe is not treated as employment for FUTA purposes if: (1) it is service which is performed before the date of enactment and with respect to which FUTA tax has not been paid; and (2) such Indian tribe reimburses a State unemployment fund for unemployment benefits paid for service attributable to such tribe for such period.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $20 million in 2001, $10 million in 2002, $9 million in 2003, to increase Federal fiscal year budget receipts by $25 million in 2004, $2 million in 2005, $2 million in 2006, to reduce budget receipts by less than $500,000 in 2007, and to increase Federal fiscal year budget receipts by $2 million in 2008, $1 million in 2009, and less than $500,000 in 2010.

TITLE II. MEDICAL SAVINGS ACCOUNTS ("MSAs")[148] (secs. 201–202 of H.R. 5662 and sec. 220 of the Code)

Present and Prior Law

Within limits, contributions to a medical savings account ("MSA")[149] are deductible in determining adjusted gross income ("AGI") if made by an eligible individual and are excludable from gross income and wages for employment tax purposes if made by the employer of an eligible individual. Earnings on amounts in an MSA are not currently taxable. Distributions from an MSA for medical expenses are not taxable. Distributions not used for medical expenses are taxable. In addition, distributions not used for medical expenses are subject to an additional 15-percent tax unless the distribution is made after age 65, death, or disability.

MSAs are available to self-employed individuals[150] and to employees covered under an employer-sponsored high deductible plan of a small employer. An employer is a small employer if it employed, on average, no more than 50 employees on business days during either the preceding or the second preceding year.

In order for an employee of a small employer to be eligible to make MSA contributions (or to have employer contributions made on his or her behalf), the employee must be covered under an employer-sponsored high deductible health plan (see the definition below) and must not be covered under any other health plan (other than a plan that provides certain permitted coverage).

Similarly, in order to be eligible to make contributions to an MSA, a self-employed individual must be covered under a high deductible health plan and no other health plan (other than a plan that provides certain permitted coverage). A self-employed individual is not an eligible individual (by reason of being self-employed) if the high deductible plan under which the individual is covered is established or maintained by an employer of the individual (or the individual's spouse).

The maximum annual contribution that can be made to an MSA for a year is 65 percent of the deductible under the high deductible plan in the case of individual coverage and 75 percent of the deductible in the case of family coverage.

A high deductible plan is a health plan with an annual deductible of at least $1,550 and no more than $2,350 in the case of individual coverage and at least $3,100 and no more than $4,650 in the case of family coverage. In addition, the maximum out-of-pocket expenses with respect to allowed costs (including the deductible) must

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[148] For legislative background of this provision, see H. Rep. 106–1033 (Oct. 26, 2000). A similar provision was included as section 303 of H.R. 5542, the "Taxpayer Relief Act of 2000", which was incorporated by reference into the conference report to H.R. 2614, "Enactment of Certain Small Business, Health, Tax, and Minimum Wage Provisions" (H. Rep. 106–1004, Oct. 26, 2000). H.R. 2614 was passed by the House on October 26, 2000, but was not brought to a vote in the Senate.

[149] In general, an MSA is a trust or custodial account created exclusively for the benefit of the account holder and is subject to rules similar to those applicable to individual retirement arrangements. The trustee of an MSA can be a bank, insurance company, or other person who demonstrates to the satisfaction of the Secretary that the manner in which such person will administer the trust will be consistent with applicable requirements.

[150] Self-employed individuals include more than 2–percent shareholders of S corporations who are treated as partners for purposes of fringe benefit rules pursuant to section 1372. Self-employed individuals are eligible for an MSA regardless of the size of the entity for which the individual performs services.

be no more than $3,100 in the case of individual coverage and no more than $5,700 in the case of family coverage.[151] A plan does not fail to qualify as a high deductible plan merely because it does not have a deductible for preventive care as required by State law. A plan does not qualify as a high deductible health plan if substantially all of the coverage under the plan is for permitted coverage (as described above). In the case of a self-insured plan, the plan must in fact be insurance (e.g., there must be appropriate risk shifting) and not merely a reimbursement arrangement.

The number of taxpayers benefiting annually from an MSA contribution is limited to a threshold level. If it is determined in a year that the threshold level has been exceeded (called a "cut-off" year) then, in general, for succeeding years during the MSA pilot period, only those individuals who (1) made an MSA contribution or had an employer MSA contribution for the year or a preceding year (i.e., are active MSA participants) or (2) are employed by a participating employer, is eligible for an MSA contribution. In determining whether the threshold for any year has been exceeded, MSAs of individuals who were not covered under a health insurance plan for the 6-month period ending on the date on which coverage under a high deductible plan commences would not be taken into account.[152] However, if the threshold level is exceeded in a year, previously uninsured individuals are subject to the same restriction on contributions in succeeding years as other individuals. That is, they would not be eligible for an MSA contribution for a year following a cut-off year unless they are an active MSA participant (i.e., had an MSA contribution for the year or a preceding year) or are employed by a participating employer.

For 1997, two thresholds applied—375,000 MSAs as of April 30, 1997, and 525,000 as of June 30, 1997. For 1998, the threshold was 600,000, and for 1999, the threshold was 750,000. The number of MSAs established has not exceeded the threshold level in any year.

Under prior law, in order to determine whether the thresholds were exceeded, MSA trustees were required to report to the IRS information regarding MSAs of which the person was a trustee. These reports were required to be made not later than August 1 of 1997, 1998, and 1999. An additional report was required for 1997, and no reports were required in 2000.

Under prior law, no numerical threshold applied for 2000. However, 2000 was an automatic cut-off year. That is, no new contributions to MSAs were permitted after December 31, 2000, except by or on behalf of individuals who previously had MSA contributions and employees who are employed by a participating employer. An employer is a participating employer if (1) the employer made any MSA contributions for any year to an MSA on behalf of employees or (2) at least 20 percent of the employees covered under a high deductible plan made MSA contributions of at least $100 in the year 2000.

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[151] These dollar amounts are for 2000. These amounts are indexed for inflation in $50 increments.

[152] Permitted coverage does not constitute coverage under a health insurance plan for this purpose.

Under prior law, self-employed individuals who made contributions to an MSA during the period 1997–2000 also could continue to make contributions after 2000.

Explanation of Provision

H.R. 5662 renames MSAs as Archer MSAs and extends the Archer MSA program through 2002. The same rules that applied to the limit on Archer MSAs for 1999 apply to 2001. Thus, for example, the threshold level in that year is 750,000. Archer MSA trustees are required to report to the IRS regarding Archer MSAs of which they are trustee no later than August 1, 2001. As under prior law, no numerical threshold or reporting requirements apply for 2000.

Effective Date

The provision is effective on the date of enactment (December 21, 2004).

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $500,000 in 2001, $3 million in 2002, $4 million in each of the years 2003 through 2007, and $3 million in each of the years 2008 through 2010.

TITLE III. ADMINISTRATIVE AND TECHNICAL CORRECTIONS PROVISIONS [153]

SUBTITLE A. ADMINISTRATIVE PROVISIONS

A. Exempt Certain Reports From Elimination Under the Federal Reports Elimination and Sunset Act of 1995 (sec. 301 of H.R. 5662)

Present and Prior Law

Section 303 of the Federal Reports Elimination and Sunset Act of 1995 eliminated many periodic Federal reporting requirements, effective May 15, 2000.

Explanation of Provision

Under the provision, certain tax-related reports are exempt from elimination and sunset pursuant to the Federal Reports Elimination and Sunset Act of 1995.

Effective Date

The provision is effective on the date of enactment (December 21, 2000).

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

B. Extension of Deadlines for IRS Compliance with Certain Notice Requirements (sec. 302 of H.R. 5662 and secs. 6631 and 6751(a) of the Code)

Present and Prior Law

The Internal Revenue Service Restructuring and Reform Act of 1998 ("RS Restructuring Act of 1998" imposed several notice requirements relating to penalties, interest and installment agreements. Section 6715 of the Code, added by section 3306 of the IRS Restructuring Act of 1998, requires that each notice imposing a penalty include the name of the penalty, the Code section under which the penalty is imposed, and a computation of the penalty.[154] This requirement applies to notices issued, and penalties assessed, after December 31, 2000.

Section 6631 of the Code, added by section 3308 of the IRS Restructuring Act of 1998, requires that every IRS notice sent to an individual taxpayer that includes an amount of interest required to be paid by the taxpayer also include a detailed computation of the interest charged and a citation to the Code section under which

[153] For legislative background of these provisions, see H. Rep. 106–1033 (Oct. 26, 2000). See also H.R. 2614, Enactment of Certain Small Business, Health, Tax, and Minimum Wage Provisions" (H. Rep. 106–1004, Oct. 26, 2000). H.R. 2614 was passed by the House on Oct. 26, 2000, but was not brought to a vote in the Senate.

[154] Sec. 671(a).

such interest is imposed. The provision is effective for notices issued after December 31, 2000.[155]

Section 3506 of the IRS Restructuring Act of 1998 requires the IRS to send every taxpayer in an installment agreement an annual statement of the initial balance owed, the payments made during the year, and the remaining balance. The provision became effective on July 1, 2000.

Explanation of Provision

The provision extends the deadlines for complying with the penalty, interest, and installment agreement notice requirements. Specifically, the annual installment agreement notice requirement is extended from July 1, 2000, to September 1, 2001. The deadlines for complying with the notice requirements relating to the computation of penalties and interest[156] are both extended to June 30, 2001. In addition, for penalty notices issued after June 30, 2001, and before July 1, 2003, the notice requirements will be treated as met if the notice contains a telephone number at which the taxpayer can request a copy of the taxpayer's assessment and payment history with respect to such penalty. Similarly, for interest notices issued after June 30, 2001, and before July 1, 2003, the notice requirements will be treated as met if such notice contains a telephone number at which the taxpayer can request a copy of the taxpayer's payment history relating to interest amounts included in such notice.

Effective Date

The provision is effective on the date of enactment (December 21, 2000).

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

C. Extension of Authority for Undercover Operations (sec. 303 of H.R. 5662 and sec. 7608 of the Code)

Present and Prior Law

The Anti-Drug Abuse Act of 1988 exempted IRS undercover operations from the otherwise applicable statutory restrictions controlling the use of Government funds (which generally provide that all receipts must be deposited in the general fund of the Treasury and all expenses be paid out of appropriated funds). In general, the exemption permits the IRS to "churn" the income earned by an undercover operation to pay additional expenses incurred in the undercover operation. The IRS is required to conduct a detailed financial audit of large undercover operations in which the IRS is churning funds and to provide an annual audit report to the Congress on all such large undercover operations. The exemption originally expired on December 31, 1989, and was extended by the Com-

[155] P.L. 105–206, sec. 3306.
[156] Secs. 6715(a) and 6631.

prehensive Crime Control Act of 1990 to December 31, 1991. In the Taxpayer Bill of Rights II (P.L. 104–168), the authority to churn funds from undercover operations was extended for five years, through 2000.

Explanation of Provision

The provision extends the authority of the IRS to "churn" the income earned from undercover operations for an additional five years, through 2005.

Effective Date

The provision is effective on the date of enactment (December 21, 2000).

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by less than $1 million in each of the years 2001 through 2007.

D. Competent Authority and Pre-Filing Agreements (sec. 304 of H.R. 5662 and secs. 6103, 6110, and new sec. 6105 of the Code)

Present and Prior Law

Section 6103

Section 6103 of the Code sets forth the general rule, under present and prior law, that returns and return information are confidential. A "return" is any tax return, information return, declaration of estimated tax, or claim for refund filed under the Code on behalf of or with respect to any person. The term "return" also includes any amendment or supplement, including supporting schedules or attachments or lists, which are supplemental to or are part of a filed return. Return information is defined broadly. Under present and prior law, "return information" includes the following information:

(1) a taxpayer's identity, the nature, source or amount of income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld, deficiencies, overassessments, or tax payments;

(2) whether the taxpayer's return was, is being, or will be examined or subject to other investigation or processing;

(3) any other data, received by, recorded by, prepared by, furnished to, or collected by the Secretary with respect to a return or with respect to the determination of the existence, or possible existence, of liability (or the amount thereof) of any person under this title for any tax, penalty, interest, fine, forfeiture, or other imposition, or offense;[157]

(4) any part of any written determination or any background file document relating to such written determination which is not open to public inspection under section 6110;[158] and

[157] Sec. 6103(b)(2)(A).
[158] Sec. 6103(b)(2)(B).

(5) any advance pricing agreement entered into by a taxpayer and the Secretary and any background information related to the agreement or any application for an advance pricing agreement.[159]

The term "return information" does not include data in a form that cannot be associated with or otherwise identify, directly or indirectly, a particular taxpayer.

Secrecy of information exchanged under tax treaties

U.S. tax treaties typically contain articles governing the exchange of information. These articles generally provide for the exchange of information between the tax authorities of the two countries when such information is necessary for carrying out provisions of the treaty or of the countries' domestic tax laws. Individuals referred to as "competent authorities" are designated by each country to make written requests for information and to receive information.[160]

The exchange of information articles typically cover information relating to taxes to which the treaty applies, but can also apply to other taxes (e.g., excise taxes) not covered by the treaty. Many of the treaties permit the exchange of information even if the taxpayer involved is not a resident of one of the treaty countries. The exchange of information articles may be similar to, or represent a variation on, Article 26 of the 1996 U.S. model income tax treaty.

Information that is received under the exchange of information articles is subject to secrecy clauses contained in the treaties. In this regard, the country requesting information under the treaties typically is required to treat any information received as secret in the same manner as information obtained under its domestic laws. In general, disclosure is not permitted other than to persons or authorities involved in the administration, assessment, collection or enforcement of taxes to which the treaty applies. For example, disclosure generally can be made to legislative bodies, such as the taxwriting committees of the Congress, and the General Accounting Office for purposes of overseeing the administration of U.S. tax laws.

In addition to the exchange of information articles in U.S. tax treaties, exchange of information provisions are contained in tax information exchange agreements entered into between the United States and another country.[161] In addition, information may be exchanged pursuant to the Convention on Mutual Administrative Assistance in Tax Matters developed by the Council of Europe and

[159] Sec. 6103(b)(2)(C) (added by the Tax Relief Extension Act of 1999, P.L. No. 106–170, sec. 521 (1999)).

[160] The U.S. competent authority is the Secretary of the Treasury or his delegate. The U.S. competent authority function has been delegated to the Commissioner of Internal Revenue, who has redelegated the authority to the Director, International (Large and Mid-size Business Division). On interpretive issues, the latter acts with the concurrence of the Associate Chief Counsel (International) of the IRS.

[161] Sections 274(h)(6)(C) and 927(e)(3) specifically provide the Secretary of the Treasury the authority to enter into tax information exchange agreements. This eliminates the need for Senate ratification, which is required for a tax treaty. In addition, all tax information exchange agreements are required to include specific non-disclosure provisions which provide "that information received by either country will be disclosed only to persons or authorities (including courts and administrative bodies) involved in the administration or oversight of, or in the determination of appeals in respect of, taxes of the United States, or the beneficiary country and will be used by such persons or authorities only for such purposes." Sec. 274(h)(6)(C)(i).

the Organization for Economic Cooperation and Development (the "Multilateral Mutual Assistance Convention"), which limits the use of exchanged information and permits disclosure of such information only with the prior authorization of the competent authority of the country providing the information.[162] The United States has also entered into a number of implementation and coordination agreements with possessions that provide for the exchange of tax information. Moreover, the United States has entered into various mutual legal assistance treaties with other countries, some of which can be used to obtain tax information in criminal investigations.

Both the confidentiality provisions of section 6103, as well as treaty secrecy provisions, can cover return information.

Section 6110 and section 7121

Present and prior law provides for disclosure of written determinations. With certain exceptions, section 6110 makes the text of any written determination the Internal Revenue Service ("IRS") issues available for public inspection. A written determination is any ruling, determination letter, technical advice memorandum, or Chief Counsel advice. The IRS is required to redact certain material before making these documents publicly available.[163] Among the information to be redacted is information specifically exempted from disclosure by any statute (other than Title 26) that is applicable to the IRS. Once the IRS makes the written determination publicly available, the background file documents associated with such written determination are available for public inspection upon written request. Section 6110 defines "background file documents" as any written material submitted by the taxpayer or other requester in support of the request. Background file documents also include any communications between the IRS and persons outside the IRS concerning such written determination that occur before the IRS issues the determination.

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[162] The U.S. Senate ratified the Multilateral Mutual Assistance Convention, subject to certain reservations, in September 1990. The Multilateral Mutual Assistance Convention entered into force on April 1, 1995, and has been signed by the following countries: Denmark, Finland, Iceland, the Netherlands, Norway, Sweden, and the United States.

[163] For rulings, determination letters and technical advice memoranda, section 6110(c) provides the following exemptions from disclosure:

(1) the names, addresses, and other identifying details of the person to whom the written determination pertains and of any other person, other than a person with respect to whom a notation is made under subsection (d)(1) (relating to third party contacts), identified in the written determination or any background file document;

(2) information specifically authorized under criteria established by an Executive order to be kept secret in the interest of national defense or foreign policy, and which is in fact properly classified pursuant to such Executive order;

(3) information specifically exempted from disclosure by any statute (other than [Title 26]) which is applicable to the Internal Revenue Service;

(4) trade secrets and commercial or financial information obtained from a person and privileged or confidential;

(5) information the disclosure of which would constitute a clearly unwarranted invasion of personal privacy;

(6) information contained in or related to examination, operating, or condition reports prepared by, or on behalf of, or for use of an agency responsible for the regulation or supervision of financial institutions; and

(7) geological and geophysical information and data, including maps, concerning wells.

For Chief Counsel Advice, paragraphs 2 through 7 do not apply, however, material may be deleted in accordance with subsections (b) and (c) of the FOIA (except that in applying Exemption 3 of the FOIA, no statutory provision of the Code is to be taken into account.) See sec. 6110(i)(3).

Section 6110 was added to the Code in 1976. The legislative history provided that a written determination would not be considered a ruling, technical advice memorandum, or determination letter, unless the document satisfies three criteria:

(1) The document recites the relevant facts;

(2) The document explains the applicable provisions of law; and

(3) The document shows the application of law to the facts.[164]

The legislative history further provided that section 6110 "does not require public disclosure of a closing agreement entered into between the IRS and a taxpayer which finally determines the taxpayer's tax liability with respect to a taxable year. . . . Your committee understands that a closing agreement is generally the result of a negotiated settlement and, as such, does not necessarily represent the IRS view of the law. Your committee intends, however, that the closing agreement exception is not to be used as a means of avoiding public disclosure of determinations which, under present practice, would be issued in a form which would be open to public inspection [under the bill]."[165]

Closing agreements are entered into under the authority of section 7121. Closing agreements finally and conclusively settle a tax issue between the IRS and a taxpayer. Closing agreements may: (1) determine a taxpayer's entire tax liability for a previous tax period; or (2) fix the tax treatment of one or more specific items affecting tax liability for any tax period. Thus, closing agreements may settle the treatment of a specific item for periods ending after the execution of the agreement. A single closing agreement may cover both the determination of a taxpayer's entire tax liability for a previous tax period and fix the tax treatment of specific items for any tax period.

Freedom of Information Act

The Freedom of Information Act ("FOIA"), enacted in 1966, established a statutory right to access government information. While the purpose of section 6103 is to restrict access to returns and return information, the basic purpose of the FOIA is to ensure that the public has access to government documents. In general, the FOIA provides that any person has a right of access to Federal agency records, except to the extent that such records (or portions thereof) are protected from disclosure by one of nine exemptions or by one of three special law enforcement record exclusions. Exemption 3 of the FOIA allows the withholding of information prohibited from disclosure by another statute if certain requirements are met.[166] The right of access is enforceable in court.

Pending FOIA requests and litigation involving IRS records

Records covered by treaty secrecy clauses

Under prior law, a publisher of tax related material and commentary has made a FOIA request for the disclosure of competent

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[164] H. Rep. 94–658, at 315 (1976).
[165] *Id.* at 316.
[166] 5 U.S.C. sec. 552(b)(3).

authority agreements on March 14, 2000.[167] The IRS did not deny the request, nor did it produce any documents responsive to the request. As of the date of enactment, no suit had been filed to compel disclosure of these documents.

In connection with a separate request, the IRS was sued under the FOIA to compel disclosure of Field Service Advice memoranda ("FSAs").[168] FSAs are prepared by attorneys in the IRS National Office of the Office of Chief Counsel. They are prepared in response to requests from IRS field personnel for legal guidance, usually with respect to issues relating to a particular taxpayer. FSAs usually contain a statement of issues, facts, legal analysis and conclusions. The primary purpose of FSAs is to ensure that IRS field personnel apply the law correctly and uniformly. The D.C. Circuit determined that FSAs are subject to disclosure. However, the court remanded the case to district court to address assertions of privilege, including those based on treaty secrecy. A decision on this issue by the district court was still pending on the date of enactment.[169]

Pre-filing agreements

On February 11, 2000, the IRS issued Notice 2000–12, in which the IRS established a pilot program for "Pre-filing Agreements." Under this program, large businesses may request a review and resolution of specific issues relating to tax returns they expect to file between September and December of 2000. The purpose of the program is to enable taxpayers and the IRS to resolve issues that are likely to be disputed in post-filing audits. Examples of such issues include: (1) asset valuation and the allocation of a business's purchase or sale price among the assets acquired or sold; (2) the identification and documentation of hedging transactions; and (3) the determination of "market" for taxpayers using the lower of cost or market method of inventory valuation in situations involving inactive markets. The program is intended to address issues for which the law is settled.

In Notice 2000–12, the IRS stated that pre-filing agreements are closing agreements entered into pursuant to section 7121. As such, the notice provides that the information generated or received by the IRS during the pre-filing agreement process constitutes return information. The notice further provides that pre-filing agreements are not written determinations as defined in section 6110, nor are they subject to disclosure under the FOIA.

Several pre-filing agreements were completed prior to the date of enactment. A FOIA request for these agreements was not made prior to the date of enactment.

Reasons for Change

Congress wished to affirm that closing and similar agreements, and information exchanged and agreements reached pursuant to a

[167] The initial FOIA request of March 14, 2000, covered all competent authority agreements executed for the United States from January 1, 1990, to date. In response to a request from the Department of Treasury, by letter dated April 17, 2000, the FOIA request was narrowed to cover competent authority agreements executed between 1997 and 1999. The right to pursue the 1990 through 1996 agreements, however, was reserved.

[168] *Tax Analysts* v. *IRS,* 117 F.3d 607 (D.C. Cir. 1997).

[169] *Tax Analysts* v. *IRS,* No. 94–CV–923 (GK) (D.D.C.).

tax treaty, are confidential. Further, Congress believed that it should be clarified that such protected documents are not to be disclosed under the FOIA or section 6110.

Explanation of Provision

Clarification that return information includes closing agreements and similar dispute resolution agreements

Protection for closing agreements, pre-filing agreements and similar agreements not containing an exposition of the tax law

The provision provides that agreements entered into under section 7121 or similar agreements are confidential return information. Similar agreements are intended to include negotiated agreements that (1) are the result of an alternative dispute resolution or dispute avoidance process relating to liability of any person under the Code for any tax, penalty, interest, fine or forfeiture or other imposition or offense and (2) do not establish, set forth, or resolve the government's interpretation of the relevant tax law. This is not meant to preclude citation, or repetition of, the Code, Treasury regulations, or other published rules.

It is intended that pre-filing agreements be covered by this provision. It is the understanding of the Congress that pre-filing agreements do not explain the applicable provisions of law or otherwise contain any exposition of the tax law or the position of the IRS. In addition, it is not intended that the closing and similar agreement exception be used as a means of avoiding public disclosure of determinations that, under present law, would be issued in a form that would be open to public inspection. Thus, technical advice memoranda, chief counsel advice or other material clearly available to the public under present law section 6110, would not be exempt from disclosure by virtue of the fact that such material is contained in a background file for a closing agreement. For example, if a revenue agent seeks technical advice in connection with a pre-filing agreement, such technical advice would remain subject to the requirements of section 6110. Since the pre-filing agreement program involves only settled issues of law, it is the understanding of the Congress that documents of this nature generally would not be generated in the pre-filing agreement process.

The provision is not intended to foreclose the disclosure of tax-exempt organization closing agreements to the extent such disclosure is authorized under section 6104.[170] Since section 6103 permits the disclosure of return information as authorized by Title 26, a disclosure authorized by section 6104 is permissible, notwithstanding the fact that a closing agreement is return information.

Report on pre-filing agreement program

It is intended that the Secretary make publicly available an annual report relating to the pre-filing agreement program operations for the preceding calendar year. The annual reporting requirement

[170] The D.C. Circuit recently remanded to the district court, for factual development, the issue of whether the closing agreement in that case was submitted in support of an exemption application, and therefore, subject to disclosure under section 6104. *Tax Analysts v. IRS,* 214 F.3d 179 (D.C. Cir. 2000), *vacating and remanding* 99–2 U.S.T.C. (CCH) par. 794 (D.D.C. 1999).

is for five years, or the duration of the program, whichever is shorter. The report is to include (1) the number of pre-filing agreements completed, (2) the number of applications received, (3) the number of applications withdrawn, (4) the types of issues which are resolved by completed agreements, (5) whether the program is being utilized by taxpayers who were previously subject to audit by the IRS, (6) the average length of time required to complete an agreement, (7) the number, if any, and subject of technical advice and chief counsel advice memoranda issued to address issues arising in connection with any pre-filing agreement, (8) any model agreements,[171] and (9) any other information the Secretary deems appropriate. The first report, covering the calendar year 2000, is to be issued no later than March 30, 2001. The information required for the annual report is subject to the restrictions of section 6103. Therefore, the Secretary will disclose information only in a form that cannot be associated with or otherwise identify, directly or indirectly, a particular taxpayer. The Joint Committee on Taxation periodically may review pre-filing agreements to determine whether they contain legal interpretations that should be disclosed to the public.

Clarification that information protected by treaty is confidential

Protection for agreements and information exchanged pursuant to tax treaty

The provision adds a new Code section 6105, which provides that tax convention information, with limited exceptions, cannot be disclosed. Thus, the provision confirms that agreements concluded under, and information received pursuant to, a tax convention are confidential and can only be disclosed as provided in such tax convention.

Under the provision, a tax convention is defined to include any income tax or gift and estate tax convention, or any other convention or bilateral agreement (including multilateral conventions and agreements and any agreement with a possession of the United States) providing for the avoidance of double taxation, the prevention of fiscal evasion, nondiscrimination with respect to taxes, the exchange of tax relevant information with the United States, or mutual assistance in tax matters.

It is the understanding of the Congress that competent authority agreements (also referred to as mutual agreements) generally do not contain an explanation of the law or application of law to facts. Instead, such agreements are negotiated arrangements to resolve issues of double taxation. Thus, the term "tax convention information" for purposes of the provision includes: (1) any agreement entered into with the competent authority of one or more foreign governments pursuant to a tax convention; (2) an application for relief under a tax convention (sought by either a taxpayer or another competent authority); (3) any background information related to

[171] *See e.g.,* Appendix A of Rev. Proc. 2000–38 which is a model "Closing Agreement on Final Determination Covering Specific Matters," regarding method of accounting for distributor commissions. Rev. Proc. 2000–38, 2000–40 I.R.B. 314–315 (October 2, 2000). That model agreement does not identify any particular taxpayer but sets forth the substance of the agreement.

such agreement or application; (4) documents implementing such agreement; and (5) any other information exchanged pursuant to a tax convention that is treated as confidential or secret under such tax convention. The Congress intends that tax convention information include documents and any other information that reflects tax convention information, including the association of a particular treaty partner with a specific issue or matter.

The general rule that tax convention information cannot be disclosed does not apply to the disclosure of tax convention information to persons or authorities (including courts and administrative bodies) that are entitled to disclosure under the tax convention. It also does not apply to any generally applicable procedural rules regarding applications for relief under a tax convention. This exception is intended to ensure that there is no restriction on the release by the Secretary of publicly available procedural rules concerning matters such as how or when to make a request for competent authority assistance. Thus, certain material generated by IRS, i.e., its Competent Authority procedures (primarily reflected in Rev. Proc. 96–13), or similar material produced by a treaty partner (for example, an Information Circular produced and published by the Canadian tax authority) may be made available to the public. The general rule does not apply to the disclosure of information not relating to a particular taxpayer if, after consultation with the parties to a tax convention, the Secretary determines that such disclosure would not impair tax administration. This is consistent with current practice. An example of a general agreement that could be disclosed under this provision is the agreement between the competent authorities of Mexico and the United States regarding the maquiladora industry. That agreement, which was not taxpayer specific, was publicized by press release IR–NT–1999–13. The Congress intends that the "impairment of tax administration" for purposes of this provision include, but not be limited to, the release of documents that would adversely affect the working relationship of the treaty partners. Under the provision, except as otherwise provided, taxpayer-specific tax convention information could not be publicly disclosed, even if it would not impair tax administration.

A taxpayer-specific competent authority agreement that relates to the existence or possible existence of liability (or amount thereof) of any person for any tax, penalty, interest, fine, forfeiture, or other imposition or offense under the Code is return information under section 6103. It is also an agreement pursuant to a tax convention under section 6105. Return information, including taxpayer-specific competent authority agreements, remains subject to the confidentiality provisions of section 6103. Thus, civil and criminal penalties for the unauthorized disclosure of returns and return information continue to apply to return information that is also covered by section 6105. However, tax convention information that is return information may only be disclosed to the extent provided in, and subject to the terms and conditions of, the relevant tax convention.

Interaction with FOIA and section 6110

Under the provision, closing agreements and similar agreements are not considered written determinations for purposes of section 6110 and, thus, are not subject to public disclosure. Such agree-

ments are defined as return information under section 6103 and, therefore, such documents are protected from disclosure pursuant to Exemption 3 of the FOIA in conjunction with section 6103.

In addition, under the provision, section 6110 does not apply to material covered by section 6105. In the litigation over FSAs, there has been some dispute as to whether treaties qualify as statutes for purposes of withholding information pursuant to Exemption 3 of the FOIA. Congress believes that treaties are the equivalent of statutes for purposes of Exemption 3 of the FOIA. Section 6105 satisfies Exemption 3 of the FOIA. Taxpayer-specific tax convention information concerning a taxpayer's tax liability, such as taxpayer-specific competent authority agreements, are exempt from the FOIA as both return information under section 6103 and information protected from disclosure by tax convention under section 6105. Agreements not relating to a particular taxpayer, and other tax convention information related to such agreements, could be disclosed under FOIA if it is determined that the disclosure would not impair tax administration.

Effective Date

The provision applies to disclosures on, or after, the date of enactment, and thus, applies to all documents in existence on, or created after, the date of enactment (December 21, 2000).

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

E. Increase Joint Committee on Taxation Refund Review Threshold to $2 Million (sec. 305 of H.R. 5662 and sec. 6405 of the Code)

Present and Prior Law

No refund or credit in excess of a specified dollar threshold of any income tax, estate or gift tax, or certain other specified taxes, may be made until 30 days after the date a report on the refund is provided to the Joint Committee on Taxation (sec. 6405). A report is also required in the case of certain tentative refunds. Additionally, the staff of the Joint Committee on Taxation conducts post-audit reviews of large deficiency cases and other select issues. Under prior law, the specified dollar threshold for review was set at $1,000,000.

Reasons for Change [172]

The Congress believed that it was appropriate to increase the refund review threshold, which had been set at $1,000,000 since 1990. Increasing it will accelerate the issuance of refunds between $1,000,000 and $2,000,000 to the taxpayers involved. In addition, this increase will free up significant resources of both the Internal Revenue Service and the staff of the Joint Committee on Taxation,

[172] H. Rep. 106–566, Taxpayer Bill of Rights 2000 (H.R. 4163), April 10, 2000, p. 60.

without materially impairing the ability to monitor problems in the administration of the tax laws.

Explanation of Provision

The provision increases the threshold above which refunds must be submitted to the Joint Committee on Taxation for review from $1,000,000 to $2,000,000. The staff of the Joint Committee on Taxation would continue to exercise its existing statutory authority to conduct a program of expanded post-audit reviews of large deficiency cases and other select issues, and the IRS is expected to cooperate fully in this expanded program.

Effective Date

The provision is effective on the date of enactment, except that the higher threshold does not apply to a refund or credit with respect to which a report was made before the date of enactment (December 21, 2000).

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

F. Clarify the Allowance of Certain Tax Benefits with Respect to Kidnapped Children (sec. 306 of H.R. 5662 and secs. 2, 24, 32, and 151 of the Code)

Present and Prior Law

The Code generally requires that a taxpayer provide over one-half of the support for each individual claimed as that taxpayer's dependent. Similarly, the child credit, the surviving spouse filing status, and the head of household filing status require that a taxpayer satisfy certain requirements with regard to individuals that qualify as the taxpayer's dependent(s). Finally, the earned income credit for taxpayers with qualifying children generally is available only if the taxpayer has the same principal place of abode for more than one-half the taxable year with an otherwise qualifying child.

Recently published IRS guidance first denied a dependency exemption to certain taxpayers with kidnapped children (TAM 200034029), then allowed such tax benefits to such taxpayers (TAM 200038059).

Explanation of Provision

H.R. 5662 clarifies that the dependency exemption, the child credit, the surviving spouse filing status, the head of household filing status, and the earned income credit are available to an otherwise qualifying taxpayer with respect to a child who is presumed by law enforcement authorities to have been kidnapped by someone who is not a member of the family of such child or the taxpayer. Generally, this treatment continues for all taxable years ending during the period that the child is kidnapped. However, this treatment ends for the taxable year ending after the calendar year in

which it is determined that the child is dead (or, if earlier, in which the child would have attained age 18).

Effective Date

The provision is effective for taxable years ending after the date of enactment (December 21, 2000).

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

G. Conforming Changes to Accommodate Reduced Issuances of Certain Treasury Securities (sec. 307 of H.R. 5662 and sec. 995(f)(4) of the Code)

Prior Law

Code section 995(f)(4) dealing with the interest charge on the deferred tax liability of the shareholders of a domestic international sales corporation provides that the interest rate be determined by reference to the average investment yield on United States Treasury bills with maturities of 52 weeks. In addition, provisions of Federal law relating to interest on monetary judgments in civil cases recovered in Federal district court and on a judgment against the United States affirmed by the Supreme Court (Title 28), interest on certain unpaid criminal fines and penalties (Title 18), and interest on compensation for certain takings of property (Title 40) determine the applicable interest rate by reference to 52-week Treasury bills.

Explanation of Provision

The Congress understood that, as a result of prior Congressional efforts at budgetary control, current and projected Federal budget surpluses were reducing the need of the Treasury Department to issue certain securities. The Treasury Department informed the Congress that on grounds of efficient debt management, and predictability and liquidity for the financial markets, the Treasury Department announced it would be likely to cease issuing 52-week Treasury bills. The provision modifies the Code (sec. 995(f)(4)) and certain other parts of Federal law relating to interest on monetary judgments in civil cases recovered in Federal district court and on a judgment against the United States affirmed by the Supreme Court (Title 28), interest on certain unpaid criminal fines and penalties (Title 18), and interest on compensation for certain takings of property (Title 40) that make specific reference to yields on 52-week Treasury bills. The provision generally replaces the reference to 52-week Treasury bills with a reference to the weekly average one-year constant maturity Treasury yield, as published by the Board of Governors of the Federal Reserve System.

Effective Date

The provision is effective upon the date of enactment (December 21, 2000).

Revenue Effect

The provision is estimated to have a negligible effect on Federal receipts.

H. Authorization of Agencies to Use Corrected Consumer Price Index (sec. 308 of H.R. 5662 and sec. 1(f) of the Code)

Present and Prior Law

Code section 1(f) provides for adjustments in the tax tables so that inflation will not result in tax increases. Numerous other provisions of the Code are indexed as well. Section 1(f) provides that inflation is measured by changes in the consumer price index ("CPI") for the preceding year as published by the Department of Labor compared to the CPI for the calendar year 1992. Section 1(f) directs the Secretary to publish tables with applicable tax rates based upon calculated inflation adjustments by December 15 of the year before the year to which the tables are to apply.

In addition, payments made under Social Security, certain Federal employee retirement programs, and certain payments to individuals under various welfare and income support programs are adjusted annually by changes in the CPI.

On September 28, 2000, the Bureau of Labor Statistics ("BLS") announced that the agency had discovered a computational error in quality adjustments of air conditioning as a part of the cost of housing resulting in errors in the reported CPI between January 1999 and August 2000. The BLS reported that the CPI levels for several months starting in January 1999 have been either 0.1, or 0.2 index points lower than the levels that would have been published without the error. Consistent with agency guidelines and past practice, the BLS announced that it is revising the reported CPI back to January 2000 to the fully correct levels. The BLS will make no change to reported levels for January through December 1999. However, the BLS will make the corrected levels of the CPI for 1999 available upon request.

Explanation of Provision

The conference agreement authorizes the Secretary of the Treasury to use the corrected levels of the CPI for 1999 and 2000 for all purposes of the Code to which they might apply. The provision conference agreement directs the Secretary of the Treasury to prescribe new tables reflecting the correct levels of the 1999 CPI for the 2001 tax year. The provision also authorities the Secretary to use corrected levels of the CPI for 1999 and 2000 for all other purposes of the Code to which the CPI applies if the Secretary determines it appropriate to use the corrected levels.

In addition, the provision provides that the Director of the Office of Management and Budget ("Director") shall assess Federal benefit programs to ascertain the extent to which the CPI error has or will result in a shortfall in program payments to individuals for 2000 and future years. The provision directs the Director to issue guidelines to agency administrators to determine the extent, if any, of such shortfalls in payments to individuals. The agency administrators are to report their findings to the Director and to Congress

within 30 days. The provision provides that, within 60 days of the date of enactment, the Director instruct the head of any Federal agency which administers an affected program to make a payment or payments to compensate for the shortfall and that such payments are targeted to the amount of the shortfall experienced by individual beneficiaries. Applicable Federal benefit programs include the old-age and survivors insurance program, the disability insurance program and the supplemental security income program under the Social Security Act and other programs as determined by the Director. The provision directs the Director to report to the Congress on the activities performed pursuant to this provision by April 1, 2001.

The Congress recognized that the error in the CPI was computational in nature. The Congress supported the BLS's policy to incorporate methodological changes only on a prospective basis. The Congress also understood that BLS policy provides that published indices generally not be revised except for those found to be in error for the year in which the error was discovered or within the past twelve months. The Congress recognize that the errors in the CPI date to as long as 20 months prior to the announcement of the error. The Congress recognized that the BLS's policy of not publishing corrected index numbers, beyond those provided as described above, has been applied in those rare cases where an error has been discovered in the past. However, the Congress understood that in the past 25 years the few errors that have been discovered have involved sub-indices and have not affected the level of the CPI itself. The last time the U.S. City Average All Items CPI was revised was in December 1974, when the values for the months of April through October 1974 were recalculated and released with issuance of the November CPI. Therefore, past precedent did not strictly apply to the present situation.

The Congress believed that integrity of official government data is vital to policymakers and private individuals and businesses throughout the country. The Congress emphasized that the CPI plays an important role in economic planning. For this reason the Congress was concerned that, while the BLS has published corrected CPI numbers for 2000, the BLS does not intend to publish corrected CPI numbers for 1999 as part of the official CPI series. To its credit, the BLS announced the error publicly. The national press reported the error.[173] In the absence of a correction to the official CPI series, the Federal government will be left in the position of maintaining, as an official data series, index numbers that the Federal government has admitted are incorrect. The Congress believed that the public's trust in the integrity of official government data is a paramount goal and the Congress strongly encouraged the Commissioner of the Bureau of Labor Statistics to review carefully

[173] For example, John M. Berry, "Inflation Higher Than Reported," *The Washington Post,* September 27, 2000, p. E–1, John M. Berry, "Rent Error Leads to Revision Of the CPI," *The Washington Post*, September 29, 2000, p. E–3, Nicholas Kulish, "Major Price Index Is Revised Upward As Result of Error," *The Wall Street Journal*, September 28, 2000, p. A2, and Nicholas Kulish, "Second-Period GDP Rose at 5.6% Annual Rate," *The Wall Street Journal*, September 29, 2000, p. A2. The conferees observe that these press reports highlight the potential confusion for the public regarding these data. *The Washington Post* reported that "the CPI figures for 1999 were not revised" (September 29, 2000 story) while *The Wall Street Journal* reported that "[t]he BLS said a complete revision of all the data sets would be released" (September 28, 2000 story) and "it [BLS] announced that it would revise the index" (September 29, 2000 story).

the agency's current policy with respect to publishing as part of an official series corrections to data found to be in error for reasons of computational error. The Congress believed such a review should be made both with respect to the error announced on September 28, 2000, and as a matter for the future for those rare circumstances where such a similar computational error might once again arise.

Effective Date

The provision is effective on the date of enactment (December 21, 2000).

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts and to increase outlays. The provision is estimated to reduce Federal fiscal year budget receipts by $9 million in 2001 and $20 million in 2002. The provision is estimated to increase Federal fiscal year outlays by $970 million in 2001, $570 million in 2002, $560 million in 2003, $550 million in 2004, $550 million in 2005, $540 million in 2006, $520 million in 2007, $520 million in 2008, $510 million in 2009, and $500 million in 2010.

I. Prevent Duplication or Acceleration of Loss Through Assumption of Certain Liabilities (sec. 309 of H.R. 5662 and sec. 358 of the Code) [174]

Present and Prior 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. However, a transferor recognizes gain to the extent it receives money or other property ("boot") as part of the exchange (sec. 351).

The assumption of liabilities by the controlled corporation generally is not treated as boot received by the transferor,[175] except that the transferor recognizes gain to the extent that the liabilities assumed exceed the total of the adjusted basis of the property transferred to the controlled corporation pursuant to the exchange (sec. 357(c)).

The assumption of liabilities by the controlled corporation generally reduces the transferor's basis in the stock of the controlled corporation that assumed the liabilities. 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

[174] See H.R. 5542, the "Taxpayer Relief Act of 2000," incorporated by reference in H.R. 2614 (H. Rep. 106–1004, Oct. 26, 2000), as passed by the House of Representatives, which contained an identical provision. On April 4, 2000, Senators Roth and Moynihan introduced a bill (S.2354) that is the same as the provision in H.R. 5542. On October 19, 1999, a substantially similar provision was released for markup by Senator Roth, the Chairman of the Senate Committee on Finance. That provision was reported by the Senate Finance Committee in S. 1792, the "Tax Relief Extension Act of 1999" (S. Rep. 106–201, Oct. 26, 1999).

[175] The assumption of liabilities is treated as boot if it can be shown that "the principal purpose" of the assumption is tax avoidance on the exchange, or is a non-bona fide business purpose (sec. 357(b)).

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 (sec. 358). For this purpose, the assumption of a liability is treated as money received by the transferor.

An exception to the general treatment of assumptions of liabilities applies to assumptions of liabilities that would give rise to a deduction, provided the incurrence of such liabilities did not result in the creation or increase of basis of any property. The assumption of such liabilities is not treated as money received by the transferor in determining whether the transferor has gain on the exchange. Similarly, the transferor's basis in the stock of the controlled corporation is not reduced by the assumption of such liabilities. The Internal Revenue Service has ruled that the assumption by an accrual basis corporation of certain contingent liabilities for soil and groundwater remediation would be covered by this exception.[176]

Reasons for Change [177]

The Congress was concerned about a type of transaction in which taxpayers seek to accelerate, and potentially duplicate, deductions involving certain liabilities. As an example, assume a transferor corporation transfers assets with a fair market value basis in exchange for preferred stock of the transferee corporation, plus the transferee's assumption of a contingent liability that is deductible in the future. The transferor claims a basis in the stock received equal to the basis of the assets. However, the value of the stock is reduced by the amount of the liability, creating a potential loss. The transferor may then attempt to accelerate the deduction that would be attributable to the liability by selling or exchanging the stock. Furthermore, the transferee might take the position that it is entitled to deduct the payments on the liability, effectively duplicating the deduction attributable to the liability.

The conference report to the Taxpayer Refund and Relief Act of 1999 contained a provision that would have amended the "principal purpose" aspect of the anti-abuse rule. The Congress believed that a different approach is more appropriate; one that eliminates any loss on the sale of stock attributable to such liabilities.

Explanation of Provision

Under the provision, if the basis of stock (determined without regard to this provision) received by a transferor as part of a tax-free exchange with a controlled corporation exceeds the fair market value of the stock, then the basis of the stock received is reduced (but not below the fair market value) by the amount (determined as of the date of the exchange) of any liability that (1) is assumed

[176] Rev. Rul. 95–74, 1995–2 C.B. 36. The ruling addressed a parent corporation's transfer to a subsidiary of substantially all the assets of a manufacturing business, in exchange for stock and the assumption of liabilities associated with the business, including certain contingent environmental remediation liabilities. These liabilities arose due to contamination of land during the parent corporation's operation of the manufacturing business. The transferor had no plan or intention to dispose of (or to have the subsidiary issue) any subsidiary stock. The IRS ruled that the contingent liabilities would not reduce the transferor's basis in the stock of the subsidiary because the liabilities had not been taken into account by the transferor prior to the transfer and had not given rise to deductions or basis for the transferor.

[177] The reasons for change are taken from S. 1792, the "Tax Relief Extension Act of 1999" (S. Rep. 106–201, Oct. 26, 1999), 47.

in exchange for such stock, and (2) did not otherwise reduce the transferor's basis of the stock by reason of the assumption. Except as provided by the Secretary of the Treasury, this provision does not apply where the trade or business with which the liability is associated is transferred to the corporation as part of the exchange, or where substantially all the assets with which the liability is associated are transferred to the corporation as part of the exchange.

The exceptions for transfers of a trade or business, or of substantially all the assets, with which a liability is associated, are intended to obviate the need for valuation or basis reduction in such cases. The exceptions are not intended to apply to situations involving the selective transfer of assets that may bear some relationship to the liability, but that do not represent the full scope of the trade or business, (or substantially all the assets) with which the liability is associated.

For purposes of the provision, the term "liability" includes any fixed or contingent obligation to make payment, without regard to whether such obligation or potential obligation is otherwise taken into account under the Code. The determination whether a liability (as more broadly defined for purposes of this provision) has been assumed is made in accordance with the provisions of section 357(d)(1) of the Code. Under the standard of 357(d)(1), a recourse liability is treated as assumed if, based on all the facts and circumstances, the transferee has agreed to and is expected to satisfy such liability (or portion thereof), whether or not the transferor has been relieved of the liability. For example, if a transferee corporation does not formally assume a recourse obligation or potential obligation of the transferor, but instead agrees and is expected to indemnify the transferor with respect to all or a portion of a such an obligation, then the amount that is agreed to be indemnified is treated as assumed for purposes of the provision, whether or not the transferor has been relieved of such liability. Similarly, a nonrecourse liability is treated as assumed by the transferee of any asset subject to such liability.[178]

The application of the provision is illustrated in the following example: Assume a taxpayer transfers assets with an adjusted basis and fair market value of $100 to its wholly-owned corporation and the corporation assumes $40 of liabilities (the payment of which would give rise to a deduction). Thus, the value of the stock received by the transferor is $60. Under prior law, the basis of the stock would have been $100. The provision requires that the basis of the stock be reduced to $60 (i.e., a reduction of $40). Except as provided by the Secretary, no basis reduction is required if the transferred assets consisted of the trade or business, or substantially all the assets, with which the liability is associated.

The provision does not change the tax treatment with respect to the transferee corporation.

The Secretary of the Treasury Secretary is directed to prescribe rules providing appropriate adjustments to prevent the acceleration or duplication of losses through the assumption of liabilities (as defined in the provision) in transactions involving partnerships. The

[178] Section 357(d)(2) contains a limitation in the case of certain nonrecourse liabilities. Also, under section 357, regulations, if issued, may provide for different results.

Secretary may also provide appropriate adjustments in the case of transactions involving S corporations. In the case of S corporations, such rules may be applied instead of the otherwise applicable basis reduction rules.

Effective Date

The provision is effective for assumptions of liabilities on or after October 19, 1999. Except as provided by the Secretary, the rules addressing transactions involving partnerships are effective for assumptions of liabilities on or after October 19, 1999. Any rules addressing transactions involving S corporations may likewise be effective for assumptions of liabilities on or after October 19, 1999, or such later date as may be prescribed in such rules.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $13 million in 2001, $15 million in 2002, $17 million in 2003, $19 million in 2004, $21 million in 2005, $23 million in 2006, $25 million in 2007, $27 million in 2008, $29 million in 2009, and $31 million in 2010.

J. Disclosure of Return Information to the Congressional Budget Office (sec. 310 of H.R. 5662 and new sec. 6103(j)(6) of the Code)

Present and Prior Law

Federal tax returns and return information are confidential and cannot be disclosed unless authorized by the Code. Section 6103 authorizes certain agencies to receive tax returns and return information for statistical use and for other specified purposes.[179] Section 6103 also permits the Secretary of the Treasury ("the Secretary") to provide return information to any person authorized to receive it by any mode or means that the Secretary determines necessary or appropriate.[180] Persons making unauthorized disclosures or inspections of tax returns and return information are subject to criminal and civil penalties.[181]

Explanation of Provision

The Congressional Budget Office ("CBO") is in the process of developing the capability to make projections of the Social Security and Medicare programs over long periods of time. To facilitate the development and operation of long-term models of Social Security and Medicare, CBO needs continuing access to records from the IRS. Specifically, CBO seeks two SSA files that contain return information—the Social Security Earnings Record and the Master Beneficiary Record. These files contain individual earnings data compiled from tax returns (Forms W–2), which are protected from disclosure by section 6103. In addition, CBO may request other records, including those matched with survey data.

[179] E.g., sec. 6103(j), and 6103(l)(l) and (5).
[180] Sec. 6103(p)(2)(B).
[181] See secs. 7431, 7213, and 7213A.

The provision amends section 6103 to permit the Secretary to furnish to CBO return information to the extent such information is necessary for purposes of CBO's long-term models of Social Security and Medicare. This authority extends to the development, operation, and maintenance by CBO of its long-term models of Social Security and Medicare. It is the intent of Congress that all requests for information made by CBO under this provision be made to the Secretary and that the Secretary use his authority under section 6103(p)(2) such that the SSA or other agency can furnish directly to CBO, for purposes of CBO's long-term models of Social Security and Medicare, the files they possess that incorporate return information. It is also the intent of Congress that the Secretary furnish such other return information under this provision as is necessary for purposes of CBO's Social Security and Medicare long-term models.

Under the provision, CBO is subject to the present-law safeguard requirements for tax returns and return information.[182] Further, CBO is prohibited from disclosing any tax returns and return information received under this provision except in a form that cannot be associated with, or otherwise identify, directly or indirectly a particular taxpayer. Present-law civil and criminal penalties apply to the unauthorized disclosure or inspection of tax returns or return information.[183]

The provision adds to the Congressional Budget Act of 1974[184] additional confidentiality provisions which would require CBO to provide the same level of confidentiality to data it obtains from other agencies as that to which the agencies themselves are subject. Officials and employees of CBO would be subject to the same statutory penalties for unauthorized disclosure as the employees of the agencies from which CBO obtain the data.

Effective Date

The provision is effective on the date of enactment (December 21, 2000).

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

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[182] Sec. 6103(p)(4).
[183] See secs. 7431, 7213, and 7213A.
[184] 2 U.S.C. sec. 601(d).

SUBTITLE B. TAX TECHNICAL CORRECTIONS [185]

Except as otherwise provided, the technical corrections contained in H.R. 5662 generally are effective as if included in the originally enacted related legislation. The provisions under the IRS Restructuring Act of 1998 relating to innocent spouse and to procedural and administrative issues (other than the provision relating to clarification of Tax Court authority to issue appealable decisions) are effective upon the date of enactment of H.R. 5662.

A. Amendments related to the Ticket to Work and Work Incentives Improvement Act of 1999

1. Research credit (sec. 311(a) of H.R. 5662 and secs. 280A(c)(1) and 30A(f) of the Code)

The provision clarifies the anti-double dip rule coordinating the research credit (sec. 41) and the Puerto Rico economic activity credit (sec. 30A). It was arguable that the prior-law provisions could be construed so that the amount of wages on which a taxpayer could claim the section 30A credit is reduced only by the amount of credit claimed under section 41, rather than by the amount of wages upon which the section 41 credit is based. This result was inconsistent with the legislative history of the original provisions. The provision deletes the words "or credit" after "deduction" in section 280C(c)(1), and adds a new subsection in section 30A specifying that wages or other expenses taken into account for section 30A may not be taken into account for section 41.

2. Taxable REIT subsidiaries (sec. 311(b) of H.R. 5662 and sec. 857(b)(7)(B) of the Code)

The provision clarifies that a REIT's redetermined rents (described in sec. 857(b)(7)(B)) that are subject to tax under section 857(b)(7)(A) do not include amounts received from a taxable REIT subsidiary that would be excluded from unrelated business taxable income (under sec. 512(b)(3), relating to certain rents, if received by certain types of organizations described in sec. 511(a)(2)).

3. Partnership basis adjustments (sec. 311(c) of H.R. 5662)

The provision provides that the rule in the consolidated return regulations (Treas. Reg. sec. 1.1502–34) aggregating stock ownership for purposes of section 332 (relating to complete liquidation of a subsidiary that is a controlled corporation) also applies for purposes of section 732(f) (relating to basis adjustments to assets of a controlled corporation received in a partnership distribution).

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[185] In addition to other tax technical corrections, H.R. 5662 contains the technical corrections contained in H.R. 2488, the Financial Freedom Act of 1999 (106th Cong., 1st Sess., reported by the House Committee on Ways and Means, H. Rep. 106–238, July 16, 1999, 393—397), as passed by the House, and S. 1429, the Taxpayer Refund Act of 1999 (106th Cong., 1st Sess., reported by the Senate Committee on Finance, S. Rep. 106–120, July 23, 1999, 221–225), as passed by the Senate. (The technical corrections were not included in the conference agreement to H.R. 2488, the Taxpayer Refund and Relief Act of 1999 (106th Cong,, 1st Sess., H. Rep. 106–289, Aug. 4, 1999, 542–543). The Taxpayer Refund and Relief Act of 1999 was vetoed by President Clinton. However, H.R. 5662 does not include the following provisions enacted in other legislation: sections 1601(b)(2) and (c) of H.R. 2488 (and section 504(c) of S. 1429), relating to the Vaccine Trust Fund, which were enacted in the "Ticket to Work and Work Incentives Improvement Act of 1999" (P.L. 106–170, sec. 523(b)).

B. Amendments related to the Tax and Trade Relief Extension Act of 1998

1. Exempt organizations (sec. 312(a) of H.R. 5662 and sec. 6104(d)(6) of the Code)

The provision clarifies that nonexempt charitable trusts and nonexempt private foundations are subject to the public disclosure requirements of section 6104(d).

2. Capital gains (sec. 312(b) of H.R. 5662)

The provision clarifies that if (1) a charitable remainder trust sold section 1250 property after July 28, 1997, and before January 1, 1998, (2) the property was held more than one year but not more than 18 months, and (3) the capital gain is distributed after December 31, 1997, then any capital gain attributable to depreciation will be taxed at 25 percent (rather than 28 percent). Treasury has published a notice (Notice 99–17, 1999–14 I.R.B., April 5, 1999) providing that the gain is taxed at 25 percent.

C. Amendments related to the Internal Revenue Service Restructuring and Reform Act of 1998

1. Innocent spouse

(a) Timing of request for relief (sec. 313(a)(1) of H.R. 5662 and sec. 6015(c)(3)(B) of the Code)

Under prior law, confusion existed as to the appropriate point at which a request for innocent spouse relief should be made by the taxpayer and considered by the IRS. Some read the statute to prohibit consideration by the IRS of requests for relief until after an assessment has been made, i.e., after the examination has been concluded, and if challenged, judicially determined. Others read the statute to permit claims for relief from deficiencies to be made upon the filing of the return before any preliminary determination as to whether a deficiency exists or whether the return will be examined. Under prior and present law, the consideration of innocent spouse relief requires that the IRS focus on the particular items causing a deficiency; until such items are identified, the IRS cannot consider these claims. Congress did not intend that taxpayers be prohibited from seeking innocent spouse relief until after an assessment has been made; Congress intended the proper time to raise and have the IRS consider a claim to be at the same point where a deficiency is being considered and asserted by the IRS. This is the least disruptive for both the taxpayer and the IRS since it allows both to focus on the innocent spouse issue while also focusing on the items that might cause a deficiency. It also permits every issue, including the innocent spouse issue, to be resolved in single administrative and judicial process.

The provision clarifies the intended time by permitting the election under section 6015(b) and (c) to be made at any point after a deficiency has been asserted by the IRS. A deficiency is considered to have been asserted by the IRS at the time the IRS states that additional taxes may be owed. Most commonly, this occurs during the Examination process. It does not require an assessment to have been made, nor does it require the exhaustion of administrative

remedies in order for a taxpayer to be permitted to request innocent spouse relief.

(b) Allowance of refunds (sec. 313(a)(2) of H.R. 5662 and sec. 6015(g) of the Code)

Under prior law, the placement in the statute of the provision for allowance of refunds may have inappropriately suggested that the provision applied only to the United States Tax Court, whereas it was intended to apply administratively and in all courts. The provision clarifies this by moving the provision to its own subsection.

(c) Non-exclusivity of judicial remedy (sec. 313(a)(3)(A) and (B) of H.R. 5662 and sec. 6015(e)(1) of the Code)

Under prior law, some suggested that the IRS Restructuring Act administrative and judicial process for innocent spouse relief was intended to be the exclusive avenue by which relief could be sought.

The provision clarifies Congressional intent that the procedures of section 6015(e) were intended to be additional, non-exclusive avenues by which innocent spouse relief could be considered.

(d) Time for filing a petition with the Tax Court (sec. 313(a)(3)(C) of H.R. 5662 and sec. 6015(e)(1)(B)(i) of the Code)

As enacted, the time period for seeking a redetermination in the Tax Court of innocent spouse relief began on the date of the determination as opposed to the day after the determination. This period was one day shorter than that generally applicable to petition the Tax Court with respect to a deficiency notice (sec. 6213) and the period during which collection activities are prohibited and the limitations period is suspended.

The provision clarifies the computation of this period and conforms it to the generally applicable 90–day period for petitioning the Tax Court. Conforming amendments are made as to the period for which collection activities are prohibited and collection limitations suspended.

(e) Waiver of final determination upon agreement as to relief (sec. 313(a)(3)(D) of H.R. 5662 and sec. 6015(e)(5) of the Code)

Congress intended in enacting section 6015 to provide a simple and efficient procedure by which the IRS could consider relief, and if relief was denied (in whole or in part) and the spouse requesting such relief did not agree with such denial, such issue could be considered by the Tax Court. Congress did not intend to require a rigid formal process when the IRS and the spouse requesting relief agreed on the extent of relief to be granted. However, the provisions of section 6015(e) under prior law have been interpreted as requiring the issuance in all circumstances of a formal "Notice of Determination," which contained a statement of the time period within which a petition may be filed with the Tax Court and which delayed final resolution of the request for relief until the expiration of the period for filing a petition with the Tax Court. The issuance

of the Notice of Determination was confusing to the taxpayer when the requested relief was fully granted or when the IRS and the taxpayer otherwise agreed on the application of the innocent spouse provisions to the taxpayer's case. It also may have caused unnecessary filings with the Tax Court and delayed the closing of the case until the time for filing with the Tax Court expired.

Congress has addressed the analogous situation in the deficiency context in section 6213(d). In such situations, upon written agreement, the IRS may adjust the taxpayer's liability as agreed, and no additional formal notice is necessary.

The provision reflects that an analogous waiver was intended to apply in the innocent spouse context. The provision consequently permits taxpayers and the IRS to enter into a similar written agreement in innocent spouse cases, which allows the taxpayer's liability to be immediately adjusted as agreed, and makes unnecessary a formal Notice of Determination or Tax Court review. This written agreement is to specify the details of the agreement between the IRS and the taxpayer as to the nature and extent of innocent spouse relief that will be provided. Conforming amendments are made as to the period for which collection activities are prohibited and collection limitations suspended.

2. Procedural and administrative issues

(a) Disputes involving $50,000 or less (sec. 313(b)(1) of H.R. 5662 and sec. 7463(f)(1) of the Code)

The provision clarifies that the small case procedures of the Tax Court are available with respect to innocent spouse disputes and disputes continuing from the pre-levy administrative due process hearing. The small case procedures provide an accessible forum for taxpayers who have small claims with less formal rules of evidence and procedure. Use of the procedure is optional to the taxpayer, with the concurrence of the Tax Court. In view of the recent enactment of the innocent spouse and pre-levy administrative due process hearing provisions, it is anticipated that the Tax Court will give careful consideration to (1) a motion by the Commissioner of Internal Revenue to remove the small case designation (as authorized by Rules 172 and 173 of the Tax Court Rules) when the orderly conduct of the work of the Court or the administration of the tax laws would be better served by a regular trial of the case, as well as (2) the financial impact upon the taxpayer, including additional legal fees and costs, of not utilizing small case treatment. For example, removing the small case designation may be appropriate when a decision in the case will provide a precedent for the disposition of a substantial number of other cases. It is anticipated that motions by the Commissioner to remove the small case designation will be made infrequently.

(b) Authority to enjoin collection actions (sec. 313(b)(2) of H.R. 5662 and secs. 6330(e)(1) and 7421(a) of the Code)

While a dispute is pending under the pre-levy administrative due process hearing procedures, levy action is statutorily suspended for that period. The Tax Court and district courts are expressly grant-

ed authority to enjoin improper levy action in general, but under prior law, that authority did not explicitly extend to improper levy action that occurs during the period when levy action was statutorily suspended under the administrative due process provisions.

The provision clarifies the ability of the courts (including the Tax Court) to enjoin levy during the period that levy is required to be suspended with respect to a dispute under the pre-levy administrative due process hearing procedures.

(c) Clarification of permissible extension of limitations period for installment agreements (sec. 313(b)(3) of H.R. 5662 and sec. 6331(k)(3) of the Code)

Under prior law, uncertainty existed as to whether the permissible extension of the period of limitations in the context of installment agreements was governed by reference to an agreement of the parties pursuant to section 6502 or by reference to the period of time during which the installment agreement was in effect pursuant to sections 6331(k)(3) and (i)(5).

The provision clarifies that the permissible extension of the period of limitations in the context of installment agreements is governed by the pertinent provisions of section 6502.[185a]

(d) Clarification of Tax Court authority to issue appealable decisions (sec. 313(d) and sec. 6330(d)(1)(A) of the Code)

Under prior law, the statutory provision for judicial review of a dispute concerning the pre-levy administrative due process hearing may have been unclear as to whether a determination of the Tax Court is an appealable decision.

The provision clarifies that the determination of the Tax Court (other than under the small case procedures) in a dispute concerning the pre-levy administrative due process hearing is a decision of the Tax Court and would be reviewable as such.

3. Other issues

(a) IRS restructuring (sec. 313(c) of H.R. 5662 and sec. 6103(k)(6) of the Code)

When the Office of the Chief Inspector was replaced by the Treasury Inspector General for Tax Administration (“TIGTA”) under the IRS Restructuring and Reform Act of 1998, Inspection’s responsibilities were assigned to the TIGTA. TIGTA personnel are Treasury, rather than IRS, personnel. TIGTA personnel still need to make investigative disclosures to carry out the duties they took over from Inspection and their additional tax administration responsibilities. However, section 6103(k)(6) refers only to “internal revenue” personnel.

The provision clarifies that section 6103(k)(6) permits TIGTA personnel to make investigative disclosures.

[185a] A further technical correction may be necessary to clarify that the elimination of the application of the section 6331(i)(5) rules applies only to section 6331(k)(2)(C).

(b) Compliance (sec. 313(e) of H.R. 5662 and sec. 6110(g)(5) of the Code)

Section 3509 of the IRS Restructuring and Reform Act of 1998 expanded the disclosure rules of section 6110 to also cover Chief Counsel advice (sec. 6110(i)).

The provision adds to section 6110(g)(5)(A), after the words technical advice memorandum, "or Chief Counsel advice." This is a conforming change related to ongoing investigations.

D. Amendments related to the Taxpayer Relief Act of 1997

1. Deficiency created by overstatement of refundable child credit (sec. 314(a) of H.R. 5662 and sec. 6211(b) of the Code)

The provision treats the refundable portion of the child credit under section 24(d) as part of a "deficiency." Thus, the usual assessment procedures applicable to income taxes will apply to both the nonrefundable and the refundable portions of the child credit. (This will reverse the conclusion reached by Internal Revenue Service Chief Counsel Memorandum 199948027 interpreting prior law.)

2. Roth IRAs (sec. 314(b) of H.R. 5662 and sec. 3405(e)(1)(B) of the Code)

Code section 3405 provides for withholding with respect to designated distributions from certain tax-favored arrangements, including IRAs. In general, under prior law, section 3405(e)(1)(B)(ii) excluded from the definition of a designated distribution the portion of any distribution which it is reasonable to believe is excludable from gross income. However, all distributions from IRAs are treated as includible in income. The exception was consistent with prior law when all IRA distributions were taxable, but does not account for the tax-free nature of certain Roth IRA distributions.

The provision extends the exception to Roth IRAs.

3. Capital gain election (sec. 314(c) of H.R. 5662)

The provision provides that an election to recognize gain or loss made pursuant to section 311(e) of the Taxpayer Relief Act of 1997 does not apply to assets disposed of in a recognition transaction within one year of the date the election would otherwise have been effective. Thus, for example, if an asset is sold in 2001, no election may be made with respect to that asset. In addition, it is clarified that the deemed sale and repurchase by reason of the election is not taken into account in applying the wash sale rules of section 1091.

4. Straight-line depreciation under AMT (sec. 314(d) of H.R. 5662 and sec. 56(a)(1) of the Code)

The provision clarifies that the Taxpayer Relief Act of 1997 did not change the requirement that the straight-line method of depreciation be used in computing the alternative minimum tax ("AMT") depreciation allowance for section 1250 property.

Under prior law, it was arguable that the changes made by that Act could be read as inadvertently allowing accelerated deprecia-

tion under the AMT for section 1250 property which is allowed accelerated depreciation under the regular tax.

5. Transportation benefits (sec. 314(e) of H.R. 5662 and secs. 403(b)(3), 414(s)(2), and 415(c)(3)(D)(ii) of the Code)

Under prior and present law, salary reduction amounts are generally treated as compensation for purposes of the limits on contributions and benefits under qualified plans. In addition, an employer can elect whether or not to include such amounts for nondiscrimination testing purposes. The IRS Reform Act permitted employers to offer a cash option in lieu of qualified transportation benefits.

The provision treats salary reduction amounts used for qualified transportation benefits the same as other salary reduction amounts for purposes of defining compensation under the qualified plan rules.

6. Tax Court jurisdiction (sec. 314(f) of H.R. 5662 and sec. 7436(a) of the Code)

The Tax Court recently held that its jurisdiction pursuant to section 7436 extends only to employment status, not to the amount of employment tax in dispute (*Henry Randolph Consulting v. Comm'r,* 112 T.C. #1, Jan. 6, 1999).

The provision provides that the Tax Court also has jurisdiction over the amount.

E. Amendments Related to the Balanced Budget Act of 1997

1. Tobacco floor stocks tax (sec. 315(a)(1) of H.R. 5662)

The provision clarifies that the floor stocks taxes imposed on January 1, 2000, and January 1, 2002, apply only to cigarettes rather than to all tobacco products.

As enacted, the law could have been construed as ambiguous, referring to imposition on all tobacco products but imposing liability only with respect to cigarettes.

2. Tobacco excise tax (sec. 315(a)(2) of H.R. 5662 and sec. 5702 of the Code)

Conforming amendments are provided to two provisions to reflect the fact that the tax on cigarette papers is not imposed on "books" of papers since January 1, 2000.

3. Coordination of trade rules and tobacco excise tax (sec. 315(a)(3) of H.R. 5662 and secs. 5761 and 5754 of the Code)

Clarification is provided that the penalty on reimporting cigarettes other than for return to a manufacturer (effective January 1, 2000) does not apply to cigarettes re-imported by individuals to the extent those cigarettes can be entered into the U.S. without duty or tax under the Harmonized Tariff Schedule.

F. Amendments related to the Small Business Job Protection Act of 1996

1. Work opportunity tax credit (sec. 316(a) of H.R. 5662 and sec. 51(d)(2) of the Code)

Under prior law, section 51(d)(2) referred to eligibility for the work opportunity tax credit with respect to certain welfare recipients without taking into account the enactment of the temporary assistance for needy families ("TANF") program.

The provisions conform references in the work opportunity tax credit to the operation of TANF.

2. Electing small business trusts holding S corporation stock (sec. 316(b) of H.R. 5662 and sec. 1361(e)(1)(A)(i) of the Code)

The provision allows an electing small business trust (sec. 1361(e)) to have an organization described in section 170(c)(1) (relating to State and local governments) as a beneficiary if the organization holds a contingent interest and is not a potential current beneficiary.

3. Definition of lump-sum distribution (sec. 316(c) of H.R. 4662 and sec. 401(k)(10)(B)(ii) of the Code)

Section 1401(b) of the Small Business Job Protection Act of 1996 Act repealed 5-year averaging for lump-sum distributions. The definition of lump-sum distribution was preserved for other provisions, primarily those relating to NUA in employer securities. The definition was moved from section 402(d)(4)(A) to section 402(e)(4)(D)(i). This definition included the following sentence: "A distribution of an annuity contract from a trust or annuity plan referred to in the first sentence of this subparagraph shall be treated as a lump sum distribution."

The provision adds this language back into the definition of lump-sum distribution. The sentence is relevant to section 401(k)(10)(B), which permits certain distributions if made as a "lump-sum distribution."

4. IRAs for nonworking spouses (sec. 316(d) of H.R. 5662 and sec. 219(c)(1)(B) of the Code)

Section 1427 of the Small Business Job Protection Act of 1996 expanded the IRA deduction for nonworking spouses. The maximum permitted IRA contributions is generally limited by the individual's earned income. However, under prior law, it was possible for a nonworking (or lesser earning) spouse to make IRA contributions in excess of the couple's combined earned income. The following example illustrates prior law.

Example: Suppose H and W retire in the middle of January 1999. In that year, H earns $1,000 and W earns $500. Both are active participants in an employer-sponsored retirement plan. Their modified AGI is $60,000. They make no Roth IRA contributions. Before application of the income phase-out rules, the maximum deductible IRA contribution that H can make is $1,000 (sec. 219(b)(1)). After application of the income phase-out rule in section 219(g), H's maximum contribution is $200, and H contributes that amount to an

IRA. Under 408(o)(2)(B), H can make nondeductible contributions of $800 ($1,000–$200).

W's maximum permitted deductible contribution under section 219(c)(1)(B), before the income phase-out, is $1,300 (the sum of H and W's earned income ($1,500), less H's deductible IRA contribution ($200)). Under the income phase-out, W's deductible contribution is limited to $200, and she can make a nondeductible contribution of $1,100 ($1,300–$200).

The total permitted contributions for H and W are $2,300 ($1,000 for H plus $1,300 for W). The combined contribution should be limited to $1,500, their combined earned income.

The provision provides that the contributions for the spouse with the lesser income cannot exceed the combined earned income of the spouses (less deductible IRA contributions or Roth IRA contributions of the spouse with the higher income).

G. Amendment related to the Revenue Reconciliation Act of 1990

1. Qualified tertiary injectant expenses (sec. 317(a) of H.R. 5662 and sec. 43(c)(1) of the Code)

The provision clarifies that the enhanced oil recovery credit (sec. 43) applies with respect to qualified tertiary injectant expenses described in section 193(b) that are paid or incurred in connection with a qualified enhanced oil recovery project, and that are deductible for the taxable year (regardless of the provision allowing the deduction). Purchased and self-produced injectants are treated the same for purposes of the section 43 credit.

H. Amendments to other Acts

1. Insurance (sec. 318(a)(1) of H.R. 5662 and sec. 7702A(a)(2) of the Code)

The legislative history of section 7702A(a) (enacted in the Technical and Miscellaneous Revenue Act of 1988) indicated that if a life insurance contract became a modified endowment contract ("MEC"), then the MEC status could not be eliminated by exchanging the MEC for another contract. Section 7702A(a)(2), however, arguably might have been read under prior law to allow a policyholder to exchange a MEC for a contract that did not fail the 7-pay test of section 7702A(b), then exchange the second contract for a third contract, which would not literally have been received in exchange for a contract that failed to meet the 7-pay test.

The provision clarifies section 7702A(a)(2) to correspond to the legislative history, effective as if enacted with the Technical and Miscellaneous Revenue Act of 1988 (generally, for contracts entered into on or after June 21, 1988).

2. Insurance (sec. 318(a)(2) of H.R. 5662 and sec. 7702A(c)(3)(A)(ii) of the Code)

Under section 7702A, if a life insurance contract that is not a modified endowment contract is actually or deemed exchanged for a new life insurance contract, then the 7-pay limit under the new contract is first be computed without reference to the premium

paid using the cash surrender value of the old contract, and then would be reduced by 1/7 of the premium paid taking into account the cash surrender value of the old contract. For example, if the old contract had a cash surrender value of $14,000 and the 7-pay premium on the new contract would equal $10,000 per year but for the fact that there was an exchange, the 7-pay premium on the new contract would equal $8,000 ($10,000–$14,000/7). However, under prior law, section 7702A(c)(3)(A) arguably might have been read to suggest that if the cash surrender value on the new contract was $0 in the first two years (due to surrender charges), then the 7–pay premium might be $10,000 in this example, unintentionally permitting policyholders to engage in a series of "material changes" to circumvent the premium limitations in section 7702A.

The provision clarifies section 7702A(c)(3)(A) to refer to the cash surrender value of the old contract, effective as if enacted with the Technical and Miscellaneous Revenue Act of 1988 (generally, for contracts entered into on or after June 21, 1988).

3. Worthless securities (sec. 318(b) of H.R. 5662 and sec. 165(g)(3) of the Code

Section 165(g)(3) provides a special rule for worthless securities of an affiliated corporation. Under prior law, the test for affiliation in section 165(g)(3)(A) was the 80-percent vote test for affiliated groups under section 1504(a) that was in effect prior to 1984. When section 1504(a) was amended in the Deficit Reduction Act of 1984 to adopt the vote and value test of present law, no corresponding change was made to section 165(g)(3)(A), even though the tests had been identical until then.

The provision conforms the affiliation test of section 165(g)(3)(A) to the test in section 1504(a)(2), effective for taxable years beginning after December 31, 1984.

4. Exception for certain annuities under OID rules (sec. 318(c) of H.R. 5662 and sec. 1275(a)(1)(b)(ii) of the Code)

The Deficit Reduction Act of 1984 expanded the prior-law rules for inclusion in income of original issue discount ("OID") on debt instruments. That Act provided an exception from the definition of a debt instrument for certain annuity contracts, including any annuity contract to which section 72 applies and that is issued by an insurance company subject to tax under subchapter L of the Code (and meets certain other requirements) (sec. 1275(a)(1)(B)(ii)).

The provision clarifies that an annuity contract otherwise meeting the applicable requirements also comes within the exception of section 1275(a)(1)(B)(ii) if it is issued by an entity described in section 501(c) and exempt from tax under section 501(a), that would be subject to tax as an insurance company under subchapter L if it were not exempt under section 501(a). For example, the provision clarifies that an annuity contract otherwise meeting the requirements that is issued by a fraternal beneficiary society which is exempt from Federal income tax under section 501(a), and which is described in section 501(c)(8), comes within the exception under section 1275(a)(1)(B)(ii). It is understood that charitable gift annuities (as defined in sec. 501(m)) depend (in whole or in substantial part) on the life expectancy of one or more individuals, and thus

come within the exception under section 1275(a)(1)(B)(i). The provision is effective as if included with section 41 of the Deficit Reduction Act of 1984 (i.e., for taxable years ending after July 18, 1984).

5. Losses from section 1256 contracts (sec. 318(d) of H.R. 5662 and sec. 6411(a) of the Code)

Under prior law, section 6411 allowed tentative refunds for NOL carrybacks, business credit carrybacks and, for corporations only, capital loss carrybacks. Under prior and present law, individuals normally cannot carry back a capital loss. However, section 1212(c) does allow a carryback of section 1256 losses, if elected by the taxpayer.

The provision amends section 6411(a) by including a reference to section 1212(c), effective as if included with section 504 of the Economic Recovery Tax Act of 1981.

6. Highway Trust Fund (sec. 318(e) of H.R. 5662 and sec. 9503(b) of the Code)

The provision modifies administrative procedures of the Highway Trust Fund to conform to the 1993 repeal of the special tax rate applicable to ethanol prior to 1994. The provision is effective for taxes received after the date of enactment. This ensures that retroactive adjustments, if any, are not made to the Highway Trust Fund.

7. Conforming amendment for expenditures from Vaccine Injury Compensation Trust Fund (sec. 318(f) of H.R. 5662 and sec. 9510(c)(1)(A) of the Code)

The provision makes a conforming amendment to the expenditure purposes of the Vaccine Injury Compensation Trust Fund to enable certain payments to be made from the Trust Fund.

I. Clerical Changes (sec. 319 of H.R. 5662)

The provisions make a number of clerical and typographical amendments to the Code.

Revenue Effect

The provisions are estimated to have no effect on Federal fiscal year budget receipts in each of the years 2001 through 2010.

TITLE IV. TAX TREATMENT OF SECURITIES FUTURES CONTRACTS[186] (SEC. 401 OF H.R. 5662 AND SECS. 1234B AND 1256 OF THE CODE)

Present and Prior Law

In general

Generally, gain or loss from the sale of property, including stock, is recognized at the time of sale or other disposition of the property, unless there is a specific statutory provision for nonrecognition (sec. 1001).

Gains and losses from the sale or exchange of capital assets are subject to special rules. In the case of individuals, net capital gain is generally subject to a maximum tax rate of 20 percent (sec. 1(h)). Net capital gain is the excess of net long-term capital gains over net short-term capital losses. Also, capital losses are allowed only to the extent of capital gains plus, in the case of individuals, $3,000 (sec. 1211). Capital losses of individuals may be carried forward indefinitely and capital losses of corporations may be carried back three years and forward five years (sec. 1212).

Generally, in order for gains or losses on a sale or exchange of a capital asset to be long-term capital gains or losses, the asset must be held for more than one year (sec. 1222).[187] A capital asset generally includes all property held by the taxpayer except certain enumerated types of property such as inventory (sec. 1221).

Section 1256 contracts

Special rules apply to "section 1256 contracts," which include regulated futures contracts, certain foreign currency contracts, nonequity options, and dealer equity options. Each section 1256 contract is treated as if it were sold (and repurchased) for its fair market value on the last business day of the year (i.e., "marked to market"). Any capital gain or loss with respect to a section 1256 contract which is subject to the mark-to-market rule is treated as if 40 percent of the gain or loss were short-term capital gain or loss and 60 percent were long-term capital gain or loss. This results in a maximum rate of 27.84 percent on any gain for taxpayers other than corporations. The mark-to-market rule (and the special 60/40 capital treatment) is inapplicable to hedging transactions.

A "regulated futures contract" is a contract (1) which is traded on or subject to the rules of a national securities exchange registered with the Securities Exchange Commission, a domestic board of trade designated a contract market by the Commodities Futures Trading Commission, or a similar exchange, board of trade, or market, and (2) with respect to which the amount required to be deposited and which may be withdrawn depends on a system of marking to market.

A "dealer equity option" means, with respect to an options dealer, an equity option purchased in the normal course of the activity of

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[186] For legislative background of these provisions, see sec. 124(c) and (d) of H.R. 4541, as passed by the House of Representatives on Oct. 19, 2000; and H. Rep. 106–1033 (December 15, 2000), pp. 1030–1037 (Joint Explanatory Statement of the Committee on Conference).

[187] The holding period for futures transactions in a commodity is 6 months. The 6-month holding period does not apply to future contracts that are subject to the mark-to-market rules of section 1256, discussed below.

dealing in options and listed on the qualified board or exchange on which the options dealer is registered. Under prior law, an equity option meant an option to buy or sell stock or an option the value of which was determined by reference to any stock, group or stocks, or stock index, other than an option on certain broad-based groups of stock or stock index.[188] An options dealer is any person who is registered with an appropriate national securities exchange as a market maker or specialist in listed options, or who the Secretary of the Treasury determines performs functions similar to market makers and specialists.[189]

Mark to market accounting for dealers in securities

A dealer in securities must compute its income from dealing in securities pursuant to the mark-to-market method of accounting (sec. 475). Gains and losses are treated as ordinary income and loss. Traders in securities, and dealers and traders in commodities may elect to use this method of accounting, including the ordinary income treatment. Section 1256 contracts generally are not treated as securities for purposes of section 475.[190]

Short sales

In the case of a "short sale" (i.e., where the taxpayer sells borrowed property and later closes the sale by repaying the lender with substantially identical property), any gain or loss on the closing transaction is considered gain or loss from the sale or exchange of a capital asset if the property used to close the short sale is a capital asset in the hands of the taxpayer, but the gain is ordinarily treated as short-term gain (sec. 1233(a)).

The Code contains several rules intended to prevent the transformation of short-term capital gain into long-term capital gain or long-term capital loss into short-term capital loss by simultaneously holding property and selling short substantially identical property (sec. 1233(b) and (d)). Under these rules, if a taxpayer holds property for less than the long-term holding period and sells short substantially identical property, any gain or loss upon the closing of the short sale is considered short-term capital gain, and the holding period of the substantially identical property is generally considered to begin on the date of the closing of the short sale. Also, if a taxpayer has held property for more than the long-term holding period and sells short substantially identical property, any loss on the closing of the short sale is considered a long-term capital loss.

For purposes of these short sale rules, property includes stock, securities, and commodity futures, but commodity futures are not considered substantially identical if they call for delivery in different months.

[188] Rev. Rul. 94–63, 1994–2 C.B. 188, provided that the determination made by the Securities and Exchange Commission would determine whether or not an option was "broad based".

[189] A special rule provides that any gain or loss with respect to dealer equity options which are allocable to limited partners or limited entrepreneurs are treated as short-term capital gain or loss and do not qualify for the 60 percent long-term, 40 percent short-term capital gain or loss treatment of section 1256(a)(3).

[190] As discussed above, dealers in equity options are subject to mark-to-market accounting and the special capital gain rules of section 1256.

For purposes of the short-sale rules relating to short-term gains, the acquisition of an option to sell at a fixed price is treated as a short sale, and the exercise or failure to exercise the option is considered a closing of the short sale.[191]

The Code also treats a taxpayer as recognizing gain where the taxpayer holds appreciated property and enters into a short sale of the same or substantially identical property, or enters into a contract to sell the same or substantially identical property (sec. 1259).

Wash sales

The wash-sale rule (sec. 1091) disallows certain losses from the disposition of stock or securities if substantially identical stock or securities (or an option or contract to acquire such property) are acquired by the taxpayer during the period beginning 30 days before the date of sale and ending 30 days after such date of sale. Commodity futures are not treated as stock or securities for purposes of this rule. The basis of the substantially identical stock or securities is adjusted to include the disallowed loss.

Similar rules apply to disallow any loss realized on the closing of a short sale of stock or securities where substantially identical stock or securities are sold (or a short sale, option or contract to sell is entered into) during the applicable period before and after the closing of the short sale.

Straddle rules

If a taxpayer realizes a loss with respect to a position in a straddle, the taxpayer may recognize that loss for the taxable year only to the extent that the loss exceeds the unrecognized gain (if any) with respect to offsetting positions in the straddle (sec. 1092). Disallowed losses are carried forward to the succeeding taxable year and are subject to the same limitation in that taxable year.

A "straddle" generally refers to offsetting positions with respect to actively traded personal property. Positions are offsetting if there is a substantial diminution of risk of loss from holding one position by reason of holding one or more other positions in personal property. A "position" in personal property is an interest (including a futures or forward contract or option) in personal property.

The straddle rules provide that the Secretary of the Treasury may issue regulations applying the short sale holding period rules to positions in a straddle. Temporary regulations have been issued setting forth the holding period rules applicable to positions in a straddle.[192] To the extent these rules apply to a position, the rules in section 1233(b) and (d) do not apply.

The straddle rules generally do not apply to positions in stock. However the straddle rules apply if one of the positions is stock and at least one of the offsetting positions is either (1) an option with respect to stock or (2) a position with respect to substantially similar or related property (other than stock) as defined in Treasury regulations. Under proposed Treasury regulations, a position with respect to substantially similar or related property does not

[191] An exception applies to an option to sell acquired on the same day as the property identified as intended to be used (and is so used) in exercising the option is acquired (sec. 1233(c)).

[192] Reg. sec. 1.1092(b)–2T.

include stock or a short sale of stock, but includes any other position with respect to substantially similar or related property.[193]

If a straddle consists of both positions that are section 1256 contracts and positions that are not such contracts, the taxpayer may designate the positions as a mixed straddle. Positions in a mixed straddle are not subject to the mark-to-market rule of section 1256, but instead are subject to rules written under regulations to prevent the deferral of tax or the conversion of short-term capital gain to long-term capital gain or long-term capital loss into short-term capital loss.

Transactions by a corporation in its own stock

A corporation does not recognize gain or loss on the receipt of money or other property in exchange for its own stock. Likewise, a corporation does not recognize gain or loss when it redeems its stock with cash, for less or more than it received when the stock was issued. In addition, a corporation does not recognize gain or loss on any lapse or acquisition of an option to buy or sell its stock (sec. 1032).

Explanation of Provision

In general

Except in the case of dealer securities futures contracts described below, securities futures contracts are not treated as section 1256 contracts. Thus, holders of these contracts are not subject to the mark-to-market rules of section 1256 and are not eligible for 60–percent long-term capital gain treatment under section 1256. Instead, gain or loss on these contracts will be recognized under the general rules relating to the disposition of property.[194]

A securities futures contract is defined in section 3(a)(55)(A) of the Securities Exchange Act of 1934, as added by the Commodity Futures Modernization Act of 2000. In general, that definition provides that a securities futures contract means a contract of sale for future delivery of a single security or a narrow-based security index. A securities futures contract will not be treated as a commodities futures contract for purposes of the Code.

Treatment of gains and losses

H.R. 5662 provides that any gain or loss from the sale or exchange of a securities futures contract (other than a dealer securities futures contract) will be considered as gain or loss from the sale or exchange of property which has the same character as the property to which the contract relates has (or would have) in the hands of the taxpayer. Thus, if the underlying security would be a capital asset in the taxpayer's hands, then gain or loss from the sale or exchange of the securities futures contract would be capital gain or loss. H.R. 5662 also provides that the termination of a securities futures contract which is a capital asset will be treated as a sale or exchange of the contract.

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[193] Prop. Reg. sec. 1.1092(d)–2(c).

[194] Any securities futures contract which is not a section 1256 contract will be treated as a "security" for purposes of section 475. Thus, for example, traders in securities futures contracts which are not section 1256 contracts could elect to have section 475 apply.

Capital gain treatment will not apply to contracts which themselves are not capital assets because of the exceptions to the definition of a capital asset relating to inventory (sec. 1221(a)(1)) or hedging (sec. 1221(a)(7)), or to any income derived in connection with a contract which would otherwise be treated as ordinary income.

Except as otherwise provided in regulations under section 1092(b) (which treats certain losses from a straddle as long-term capital losses) and section 1234B, as added by H.R. 5662, any capital gain or loss from the sale or exchange of a securities futures contract to sell property (i.e., the short side of a securities futures contract) will be short-term capital gain or loss. In other words, a securities futures contract to sell property is treated as equivalent to a short sale of the underlying property.

Wash sale rules

H.R. 5662 clarifies that, under the wash sale rules, a contract or option to acquire or sell stock or securities shall include options and contracts that are (or may be) settled in cash or property other than the stock or securities to which the contract relates. Thus, for example, the acquisition, within the period set forth in section 1091, of a securities futures contract to acquire stock of a corporation could cause the taxpayer's loss on the sale of stock in that corporation to be disallowed, notwithstanding that the contract may be settled in cash.

Short sale rules

In applying the short sale rules, a securities futures contract to acquire property will be treated in manner similar to the property itself. Thus, for example, the holding of a securities futures contract to acquire property and the short sale of property which is substantially identical to the property under the contract will result in the application of the rules of section 1233(b).[195] In addition, as stated above, a securities futures contract to sell is treated in a manner similar to a short sale of the property.

Straddle rules

Stock which is part of a straddle at least one of the offsetting positions of which is a securities futures contract with respect to the stock or substantially identical stock will be subject to the straddle rules of section 1092. Treasury regulations under section 1092 applying the principles of the section 1233(b) and (d) short sale rules to positions in a straddle will also apply.

For example, assume a taxpayer holds a long-term position in actively traded stock that is a capital asset in the taxpayer's hands and enters into a securities futures contract to sell substantially identical stock (at a time when the position in the stock has not appreciated in value so that the constructive sale rules of section 1259 do not apply). The taxpayer has a straddle. Treasury regulations prescribed under section 1092(b) applying the principles of

[195] Because securities futures contracts are not treated as futures contracts with respect to commodities, the rule providing that commodity futures are not substantially identical if they call for delivery in different months does not apply.

section 1233(d) will apply, so that any loss on closing the securities futures contract will be a long-term capital loss.

Section 1032

A corporation will not recognize gain or loss on transactions in securities futures contracts with respect to its own stock.

Holding period

If property is delivered in satisfaction of a securities futures contract to acquire property (other than a contract to which section 1256 applies), the holding period for the property will include the period the taxpayer held the contract, provided that the contract was a capital asset in the hands of the taxpayer.

Regulations

The Secretary of the Treasury or his delegate has the authority to prescribe regulations to provide for the proper treatment of securities futures contracts under provisions of the Internal Revenue Code.

Dealers in securities futures contracts

In general, H.R. 5662 provides that securities futures contracts and options on such contracts are not section 1256 contracts. H.R. 5662 provides, however, that "dealer securities futures contracts" will be treated as section 1256 contracts.

The term "dealer securities futures contract" means a securities futures contract which is entered into by a dealer in the normal course of his or her trade or business activity of dealing in such contracts, and is traded on a qualified board of trade or exchange. The term also includes any option to enter into securities futures contracts purchased or granted by a dealer in the normal course of his or her trade or business activity of dealing in such options. The determination of who is to be treated as a dealer in securities futures contracts is to be made by the Secretary of the Treasury or his delegate not later than July 1, 2001. Accordingly, H.R. 5662 authorizes the Secretary to treat a person as a dealer in securities futures contracts or options on such contracts if the Secretary determines that the person performs, with respect to such contracts or options, functions similar to an equity options dealer, as defined under present law.

The determination of who is a dealer in securities futures contracts is to be made in a manner that is appropriate to carry out the purposes of the provision, which generally is to provide comparable tax treatment between dealers in securities futures contracts, on the one hand, and dealers in equity options, on the other. Although traders in securities futures contracts (and options on such contracts) may not have the same market-making obligations as market makers or specialists in equity options, many traders are expected to perform analogous functions to such market makers or specialists by providing market liquidity for securities futures contracts (and options) even in the absence of a legal obligation to do so. Accordingly, the absence of market- making obligations is not inconsistent with a determination that a class of traders are dealers in securities futures contracts (and options), if the relevant fac-

tors, including providing market liquidity for such contracts (and options), indicate that the market functions of the traders is comparable to that of equity options dealers.

As in the case of dealer equity options, gains and losses allocated to any limited partner or limited entrepreneur with respect to a dealer securities futures contract will be treated as short-term capital gain or loss.

Treatment of options under section 1256

H.R. 5662 modifies the definition of "equity option" for purposes of section 1256 to take into account changes made by the Commodity Futures Modernization Act of 2000. Only options dealers are eligible for section 1256 treatment with respect to equity options. The term "equity option" is modified to include an option to buy or sell stock, or an option the value of which is determined, directly or indirectly, by reference to any stock, or any "narrow-based security index," as defined in section 3(a)(55) of the Securities Exchange Act of 1934, as added by the Commodity Futures Modernization Act of 2000. An equity option includes an option with respect to a group of stocks only if the group meets the requirements for a narrow-based security index.

As under prior law, listed options that are not "equity options" are considered "nonequity options" to which section 1256 applies for all taxpayers. For example, options relating to broad-based groups of stocks and broad based stock indexes will continue to be treated as nonequity options under section 1256.

Definition of contract markets

The Commodity Futures Modernization Act of 2000 designates certain new contract markets. The new contract markets will be contract markets for purposes of the Code, except to the extent provided in Treasury regulations.

Effective Date

These provisions take effect on the date of enactment (December 21, 2000).

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

PART NINE: INSTALLMENT TAX CORRECTION ACT OF 2000 (PUBLIC LAW 106–573)[196]

Present and Prior Law

The installment method of accounting allows a taxpayer to defer the recognition of income from the disposition of certain property until payment is received. Sales to customers in the ordinary course of business are not eligible for the installment method, except for sales of property that is used or produced in the trade or business of farming and sales of timeshares and residential lots if an election to pay interest under section 453(l)(2)(B) is made. Section 536(a) of the Ticket to Work and Work Incentives Improvement Act of 1999 prohibited the use of the installment method for a transaction that would otherwise be required to be reported using an accrual method of accounting, effective for dispositions occurring on or after December 17, 1999.

A pledge rule provides that if an installment obligation is pledged as security for any indebtedness, the net proceeds[197] of such indebtedness are treated as a payment on the obligation, triggering the recognition of income. Actual payments received on the installment obligation subsequent to the receipt of the loan proceeds are not taken into account until such subsequent payments exceed the loan proceeds that were treated as payments.

The pledge rule does not apply to sales of property used or produced in the trade or business of farming, to sales of timeshares and residential lots where the taxpayer elects to pay interest under section 453(l)(2)(B), or to dispositions where the sales price does not exceed $150,000. The Ticket to Work and Work Incentives Improvement Act of 1999 provided that the right to satisfy a loan with an installment obligation will be treated as a pledge of the installment obligation, effective for dispositions occurring on or after December 17, 1999.

Explanation of Provision

The Act repeals the prohibition on the use of the installment method of accounting for dispositions of property that would otherwise be reported for Federal income tax purposes using an accrual method of accounting. The Act reverses this prohibition as if section 536(a) of the Ticket to Work and Work Incentives Improvement Act of 1999 had not been enacted. Accordingly, any disposition of property that otherwise qualifies to be reported using the

[196] H.R. 3594 was passed by the House under suspension of the rules, without having been reported by any committee, on December 15, 2000. H.R. 3594 was passed without amendment by unanimous consent by the Senate on December 15, 2000. The bill was signed by the President on December 28, 2000.

[197] The net proceeds equal the gross loan proceeds less the direct expenses of obtaining the loan.

installment method of accounting may be reported using that method without regard to whether the disposition would otherwise be reported using an accrual method of accounting.

The Act leaves unchanged the rule added by section 536(b) of the Ticket to Work and Work Incentives Improvement Act of 1999 that modified the installment method pledge rule.

Effective Date

The provision is effective for sales or other dispositions on or after December 17, 1999.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $1,120 million in 2001, $394 million in 2002, $249 million in 2003, $70 million in 2004, $8 million in 2005, $20 million in 2006, $34 million in 2007, $47 million in 2008, $60 million in 2009, and $76 million in 2010.

A P P E N D I X:

ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION

ENACTED IN THE 106TH CONGRESS

APPENDIX:
ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN THE 106TH CONGRESS

Fiscal Years 1999–2010

[Millions of Dollars]

Provision	Effective	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	1999–10
PART ONE: AVAILABILITY OF CERTAIN TAX BENEFITS FOR SERVICES FOR PART OF OPERATION ALLIED FORCE (Relating to Tax Relief for Personnel in Yugoslavia, Albania, the Adriatic Sea, and the Northern Ionian Sea; Estimate Includes the Effect of the Executive Order Signed by the President on April 13, 1999, Declaring These Areas a Combat Zone) (P.L. 106–21, signed into law by the President on April 19, 1999)														
A. Designate “Qualified Hazardous Duty Area” to Include Yugoslavia, Albania, the Adriatic Sea, and the Northern Ionian Sea	3/24/99							*No Revenue Effect*						
B. Provide Section 7508 Suspensions to Certain Military Personnel Outside of Hazardous Duty Area	3/24/99							*Negligible Revenue Effect*						
SUBTOTAL OF PART ONE: AVAILABILITY OF CERTAIN TAX BENEFITS FOR SERVICES FOR PART OF OPERATION ALLIED FORCE								***Negligible Revenue Effect***						

PART TWO: MISCELLANEOUS TRADE AND TECHNICAL CORRECTIONS ACT OF 1999—Clarify the Meaning of "Subject to" Liabilities Under Section 357(c) (P.L. 106–36, signed into law by the President on June 25, 1999)	**to/a 10/19/98**	**7**	**12**	**14**	**16**	**18**	**20**	**22**	**24**	**26**	**28**	**30**	**32**	**249**
PART THREE: TAX RELIEF EXTENSION ACT OF 1999 (TITLE V. OF THE "TICKET TO WORK AND WORK INCENTIVES IMPROVEMENT ACT OF 1999") (P.L. 106–170, signed into law by the President on December 17, 1999)														
Title I. Extension of Expiring Provisions														
A. Treatment of Nonrefundable Personal Credits Under the Alternative Individual Minimum Tax (through 12/31/01)	tybi 1999		−972	−977	−943									−2,892
B. Extend Research Tax Credit (through 6/30/04), and Increase AIC Rates by 1 Percentage Point, and Expand to Puerto Rico and the Other Possessions; Delay Claiming of Credit (1)	(2)			−1,661	−4,082	−2,541	−2,242	−1,343	−708	−386	−150	−26		−13,139
C. Exemption from Subpart F for Active Financing Income (through 12/31/01)	tyba 12/31/99		−187	−785	−744									−1,716
D. Suspension of 100% Net Income Limitation for Marginal Properties (through 12/31/01)	DOE		−23	−35	−12									−71
E. Work Opportunity Tax Credit (through 12/31/01)	wpoifibwa 6/30/99		−229	−321	−293	−151	−58	−19	−3					−1,073
F. Welfare-to-Work Tax Credit (through 12/31/01)	wpoifibwa 6/30/99		−49	−77	−79	−47	−19	−7	−2					−281

APPENDIX:—Continued

ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN THE 106TH CONGRESS

Fiscal Years 1999–2010

[Millions of Dollars]

Provision	Effective	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	1999–10
G. Extension of Employer Provided Educational Assistance for Undergraduate Courses (through 12/31/01)	cba 5/31/00	....	−134	−318	−132	....	....	....	....	....	....	....	....	−584
H. Extend and Modify Tax Credit for Electricity Produced From Wind and Closed-Loop Biomass Facilities Placed in Service Through 12/31/01—credit to include electricity produced from poultry waste	DOE [3]	....	−9	−25	−33	−33	−34	−35	−36	−37	−38	−38	−39	−357
I. Reauthorization of Generalized System of Preferences (through 9/30/01) [4]	7/1/99	....	−438	−360	....	....	....	....	....	....	....	....	....	−798
J. Extend Qualified Zone Academy Bond Program (3-year carryforward for 1998 and 1999 authority; 2-year carryforward thereafter) (through 12/31/01)	DOE	....	−3	−11	−20	−28	−30	−30	−30	−30	−30	−30	−30	−272
K. Extend the $5,000 Credit for First-Time Homebuyers in the District of Columbia (through 12/30/01)	rpa 12/31/00	....	....	−5	−15	[5]	[5]	[5]	[5]	[5]	[5]	[5]	[5]	−20
L. Extend Brownfields Environmental Remediation (through 12/31/01)	DOE	....	11	−43	−59	−20	−2	−1	2	5	6	8	10	−83
M. Increase Amount of Rum Excise Tax That is Covered Over to Puerto Rico and the U.S. Virgin Islands (from $10.50 per proof gallon to $13.25 per proof gallon) (through 12/31/01) [4] [6]	DOE	....	−20	−115	−15	....	....	....	....	....	....	....	....	−150

Title II. Other Time-Sensitive Provisions														
A. Prohibit Disclosure of Advance Pricing Agreements (APAs) and Related Information; Require the IRS to Submit to Congress an Annual Report of Such Agreements ..	DOE	....					*No Revenue Effect*	....						
B. Authority to Postpone Certain Tax-Related Deadlines by Reason of Year 2000 Failures	DOE	....					*Negligible Revenue Effect*	....						
C. Add the Streptococcus Pneumoniae Vaccine to the List of Taxable Vaccines in the Federal Vaccine Insurance Program	sa DOE	....	4	7	9	10	10	10	10	10	10	11	11	102
D. Delay the Requirement that Registered Motor Fuels Terminals Offer Dyed Kerosene as a Condition of Registration (through 12/31/01)	DOE	....					*Negligible Revenue Effect*	....						
E. Provide that Federal Farm Production Payments are Taxable in the Year of Receipt (ignore election to take the payments in an earlier year unless exercised)	DOE	....					*Negligible Revenue Effect*	....						
Title III. Revenue Offset Provisions														
A. General Provisions														
1. Modify individual estimated tax safe harbor to 108.6% for tax year 2000 and 110% for tax year 2001	tyba 12/31/99	....	1,560	840	−2,400	....								
2. Clarify the tax treatment of income and losses from derivatives	DOE	....	(7)	1	1	1	1	1	1	1	1	1	1	10
3. Information reporting on cancellation of indebtedness by non-bank financial institutions	doia 12/31/99	....	....	7	7	7	7	7	7	7	7	7	7	70

APPENDIX:—Continued
ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN THE 106TH CONGRESS

Fiscal Years 1999–2010

[Millions of Dollars]

Provision	Effective	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	1999–10
4. Prevent the conversion of ordinary income or short-term capital gains into income eligible for long-term capital gain rates ...	teio/a 7/12/99	...	15	45	47	49	51	54	58	62	66	70	74	591
5. Allow employers to transfer excess defined benefit plan assets to a special account for health benefits of retirees (through 12/31/05) ...	tmi tyba 12/31/00	...	...	19	38	39	40	43	23	...	...	...	...	200
6. Repeal installment method for most accrual basis taxpayers; adjust pledge rules ...	iso/a DOE	...	489	694	416	257	72	10	21	35	48	62	78	2,182
7. Deny deduction and impose excise tax with respect to charitable split-dollar life insurance arrangements ...	(8)	...	...	...	...	*Negligible Revenue Effect*				...	...	...	...	...
8. Distributions by a partnership to a corporate partner of stock in another corporation ..	(9)	...	2	4	7	10	10	10	10	10	10	10	10	93
B. Real Estate Investment Trust (REIT) Provisions														
1. Impose 10% vote or value test ...	tyba 12/31/00	...	...	2	8	8	8	9	9	9	10	10	10	83
2. Treatment of income and services provided by taxable REIT subsidiaries, with 20% asset limitation ...	tyba 12/31/00	...	...	50	131	44	19	−9	−39	−72	−107	−146	−188	−317

Provision	Effective													Total
3. Personal property treatment for determining rents from real property for REITs	tyba 12/31/00	....	....	−1	−1	−1	−1	−1	−1	−1	−1	−1	−1	−7
4. Special foreclosure rule for health care REITs	tyba 12/31/00						*Negligible Revenue Effect*							
5. Conformity with RIC 90% distribution rules	tyba 12/31/00	....	....	−1	1	1	1	1	1	1	1	1	1	6
6. Clarification of definition of independent operators for REITs	tyba 12/31/00						*Negligible Revenue Effect*							
7. Modification of earnings and profits rules	da 12/31/00	....	....	−6	−3	−3	−3	−4	−4	−4	−4	−4	−4	−39
8. Modify estimated tax rules for closely-owned REIT dividends	epdo/a 12/15/99	....	40	1	1	1	1	1	1	1	1	1	1	53
SUBTOTAL OF PART THREE: TAX RELIEF EXTENSION ACT OF 1999		....	**57**	**−3,069**	**−8,165**	**−2,397**	**−2,169**	**−1,303**	**−680**	**−389**	**−170**	**−64**	**−59**	**−18,409**
PART FOUR: TRADE AND DEVELOPMENT ACT OF 2000 (P.L. 106–200, signed into law by the President on May 18, 2000)														
A. Application of Denial of Foreign Tax Credit Regarding Trade and Investment With Respect to Certain Foreign Countries	o/a 2/1/01						*No Revenue Effect*							
B. Accelerate Rum Excise Tax Coverover Payments to Puerto Rico and the U.S. Virgin Islands (4)	DOE	....	−51	51	....	....	....	....	....	....	....	....	....	....
SUBTOTAL OF PART FOUR: TRADE AND DEVELOPMENT ACT OF 2000		....	**−51**	**51**	....	....	....	....	....	....	....	....	....	....

APPENDIX:—Continued
ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN THE 106TH CONGRESS

Fiscal Years 1999–2010

[Millions of Dollars]

Provision	Effective	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	1999–10
PART FIVE: FULL AND FAIR POLITICAL ACTIVITY DISCLOSURE ACT OF 2000—Require Section 527 Organizations and Certain Tax-Exempt Organizations to Disclose Their Political Activities and Contributions (P.L. 106–230, signed into law by the President on July 1, 2000	**[10]**							***Negligible Revenue Effect***						
PART SIX: MISCELLANEOUS TRADE AND TECHNICAL CORRECTIONS ACT OF 2000—Relating to Imported Cigarette Compliance (P.L. 106–476, signed into law by the President on November 9, 2000)	**generally DOE**							***No Revenue Effect***						
PART SEVEN: FSC REPEAL AND EXTRATERRITORIAL INCOME EXCLUSION ACT OF 2000—FSC Repeal; Extraterritorial Income Exclusion (P.L. 106–519, signed into law by the President on November 15, 2000)	**generally ta 9/30/00**			**−153**	**−315**	**−348**	**−384**	**−423**	**−466**	**−514**	**−566**	**−623**	**−687**	**−4,479**

PART EIGHT: COMMUNITY RENEWAL TAX RELIEF ACT OF 2000 (P.L. 106–554, signed into law by the President on December 21, 2000)

Title I. Community Revitalization Provisions

A. Tax Incentives for Renewal Communities and Empowerment Zones														
1. Designate 40 renewal communities, 12 of which are in rural areas, to receive the following tax benefits: a wage credit of 15% on first $10,000 of qualified wages; an additional $35,000 of section 179 expensing; deduction for qualified revitalization expenditures, capped at $12 million per community; and 0% capital gains tax rate on qualifying assets held more than 5 years	(11)	....	....	....	−364	−591	−564	−579	−624	−701	−910	−950	−369	−5,654
2. Designate 9 new empowerment zones, extend present-law empowerment zone designations through 12/31/09, expand the 20% wage credit to all empowerment zones, increase the additional section 179 expensing to $35,000 for all empowerment zones including D.C. in 2002 and 2003, and extend the more favorable round II tax exempt financing rules to all existing and new empowerment zones excluding D.C.	DOE (12)	....	....	....	−243	−470	−470	−537	−592	−599	−615	−783	−239	−4,548
3. Capital gain rollover of empowerment zone assets and increased exclusion of gain on sale of certain empowerment zone investments	qapa DOE & qspa DOE	....	....	(5)	−3	−15	−32	−52	−71	−93	−118	−152	−202	−738

APPENDIX:—Continued
ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN THE 106TH CONGRESS

Fiscal Years 1999–2010

[Millions of Dollars]

Provision	Effective	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	1999–10
B. New Markets Tax Credit—provide new markets tax credit with allocation authority of $1.0 billion in 2001, $1.5 billion in 2002 and 2003, $2.0 billion in 2004 and 2005, and $3.5 billion in 2006 and 2007	qima 12/31/00	....	....	−2	−18	−115	−246	−365	−531	−725	−813	−828	−747	−4,391
C. Increase the Low-Income Housing Tax Credit and Other Modifications—increase per capita credit to $1.50 in 2001, $1.75 in 2002, and indexed for inflation thereafter; $2 million small State minimum in 2001 and 2002 and index for inflation thereafter; modify stacking rules and credit allocation rules; certain Native American housing assistance disregarded in determining whether building is Federally subsidized for purposes of the low-income housing credit	generally cyba 12/31/00	....	....	−9	−52	−148	−282	−433	−598	−779	−976	−1,188	−1,416	−5,880
D. Private Activity Bond State Volume Limits—increase annual State volume cap to the greater of: $62.50 per resident or $187.5 million in 2001, and $75 per resident or $225 million in 2002; index for inflation thereafter	cyba 12/31/00	....	....	−16	−95	−195	−284	−361	−425	−473	−513	−557	−600	−3,519

E. Expensing of Environmental Remediation Expenditures and Expansion of Qualifying Sites—for expenditures incurred before 2004 (“Brownfields“)	DOE & epoia DOE		−13	−97	−225	−165	−39	−1	5	17	17	12	−489
F. Extend the D.C. Homebuyer Credit Through 12/31/03	DOE		[7]	−7	−25	−14	[5]	[5]	[5]	[5]	[5]	[5]	−46
G. Extend the D.C. Enterprise Zone Through 12/31/03	DOE				−42	−26	−15	−15	−16	−19	−34	−36	−203
H. Extend Present-Law Section 170(e)(6) Relating to Corporate Contributions of Computer Equipment Through 12/31/03; Expand List of Eligible Donees to Include Public Libraries; Expand to Include a 3-Year Property; Include Reacquired Computers	cma 12/31/00		−63	−118	−126	−63	−3						−373
I. Treatment of Indian tribes as Non-Profit Organizations and State or Local Governments for Purposes of the Federal Unemployment Tax [4]	[13]		−20	−10	−9	25	2	2	[5]	2	1	[7]	−9
Title II. Two-Year Extension of Availability of Medical Savings Accounts	**DOE**		**[5]**	**−3**	**−4**	**−4**	**−4**	**−4**	**−4**	**−3**	**−3**	**−3**	**−33**
Title III. Administrative and Technical Provisions													
A. Administrative Provisions													
1. Exempt certain reports from elimination under the Federal Reports Elimination And Sunset Act of 1995	DOE						*No Revenue Effect*						
2. Extension of deadlines for IRS compliance with certain notice requirements	DOE						*No Revenue Effect*						
3. 5-year extension of authority for IRS undercover operations	DOE		[14]	[14]	[14]	[14]	[14]	[14]	[14]				[15]
4. Confidentiality of certain documents relating to closing and similar agreements and to agreements with foreign governments	DOE						*Negligible Revenue Effect*						

APPENDIX:—Continued

ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN THE 106TH CONGRESS

Fiscal Years 1999–2010

[Millions of Dollars]

Provision	Effective	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	1999–10
5. Increase in Joint Committee on Taxation refund review threshold to $2 million	DOE						*Negligible Revenue Effect*							
6. Clarify dependency deduction for kidnapped children	tyea DOE						*Negligible Revenue Effect*							
7. Conforming changes to accommodate reduced issuances of certain Treasury securities	DOE						*Negligible Revenue Effect*							
8. Authorization to Use Corrected Consumer Price Index:														
a. Tax revenues (16)	DOE			−9	−20									−29
b. Outlays (4) (7) (18)	DOE			−970	−570	−560	−550	−550	−540	−520	−520	−510	−500	−5,790
9. Prevent duplication or acceleration of loss through assumption of certain liabilities	aolo/a 10/19/99			13	15	17	19	21	23	25	27	29	31	220
10. Disclosure of certain return information to the Congressional Budget Office	DOE						*No Revenue Effect*							
B. Technical Correction Provisions							*No Revenue Effect*							
Title IV. Tax Treatment of Securities Futures Contracts	**DOE**						***Negligible Revenue Effect***							
SUBTOTAL OF PART EIGHT: COMMUNITY RENEWAL TAX RELIEF ACT OF 2000				**−1,089**	**−1,585**	**−2,508**	**−2,656**	**−2,915**	**−3,376**	**−3,880**	**−4,441**	**−4,958**	**−4,069**	**−31,479**

Provision	Effective												
PART NINE: INSTALLMENT TAX CORRECTION ACT OF 2000—Permit Installment Method for Accrual Basis Taxpayers (P.L. 106–573, signed into law by the President on December 28, 2000)	**soodo/a 12/17/99**		**−1,120**	**−394**	**−249**	**−70**	**−8**	**−20**	**−34**	**−47**	**−60**	**−76**	**−2,078**

Joint Committee on Taxation.

NOTE: Details may not add to totals due to rounding.

Legend for "Effective" column:

aolo/a = assumption of liabilities on or after
cma = contributions made after
cba = courses beginning after
cyba =calendar years beginning after
da = distributions after
DOE = date of enactment
doia = discharges of indebtedness after
epdo/a = estimated payments due on or after
epoia = expenditures paid or incurred after
iso/a = installment sales on or after
o/a = on or after
qapa = qualifying assets purchased after
qima =qualified investments made after
qspa=qualified stock purchased after
rpa = residences purchased after
sa = sales after
soodo/a = sales or other dispositions on or after
ta = transactions after
teio/ a = transactions entered into on or after
tmi = transfers made in
to/a = transfers on or after
tyba =taxable years beginning after
tyea = taxable years ending after
tybi = taxable years beginning in
wpoifbwa = wages paid or incurred for individuals beginning work after

[1] For expenses incurred after 6/30/99 and before 10/1/00, credit cannot be claimed until after 9/30/00. For expenses incurred after 9/30/00 and before 10/1/01, credit cannot be claimed until after 9/30/01.

[2] Extension of credit effective for expenses incurred after 6/30/99; increase in AIC rates effective for taxable years beginning after 6/30/99; expansion of the credit to include U.S. possessions effective for expenditures paid or incurred beginning after 6/30/99.

[3] For wind and closed-loop biomass, provision applies to production from facilities in service after 6/30/99 and before 1/1/02; for poultry waste, provision applies to production from facilities placed in service after 12/31/99 and before 1/1/02.

[4] Estimate provided by the Congressional Budget Office.

[5] Loss of less than $500,000.

[6] A special rule applies to the payment of the $2.75 increases in the cover-over rate for periods before 10/1/00.

[7] Gain of less than $500,000.

[8] Effective for transfers made after 2/8/99 and for premiums paid after the date of enactment.

[9] Effective 7/14/99 (except with respect to partnerships in existence on 7/14/99, the provision is effective 6/30/01).

[10] Effective for expenditures made and contributions received in reporting periods beginning after the date of enactment and for expenditures made and contributions received in annual reporting periods ending after the date of enactment. The general reporting requirements of disclosable activities are effective on the date of enactment.

[11] Renewal communities must be designated during the period beginning on the first day of the first month after the publication of regulations by HUD and ending on 12/31/01. The tax benefits for the designated communities generally are effective beginning on 1/1/02, and terminating on 12/31/09.

[Footnotes for the Appendix are continued on the following page]

APPENDIX:—Continued
ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN THE 106TH CONGRESS

Fiscal Years 1999–2010

[Millions of Dollars]

[12] Area may be designated as an empowerment zone any time after the date of enactment and before 1/1/02. The tax benefits generally become effective after 12/31/01 and terminate on 12/31/09.

[13] The proposal generally would be effective with respect to service performed beginning on or after the date of enactment. Under a transition rule, service performed in the employ of an Indian tribe would not be treated as employment for FUTA purposes if: (1) it is service which is performed before the date of enactment and with respect to which FUTA tax has not been paid; and (2) such Indian tribe reimburses a State unemployment fund for unemployment benefits paid for service attributable to such tribe for such period.

[14] Gain of less than $1 million.

[15] Gain of less than $10 million.

[16] Estimate for fiscal year 2002 includes an increase in EIC outlays of $17 million.

[17] Negative numbers indicate a increase in Federal outlays.

[18] Estimate includes outlays of $4.1 billion over the Federal fiscal year period 2001–2010 from the Social Security trust fund.

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