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U.S. HOUSE OF REPRESENTATIVES

WRITTEN COMMENTS

ON

H.R. 3376, THE "TAX TECHNICAL CORRECTIONS ACT OF 2005"

AUGUST 31, 2005

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ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
July 22, 2005
No. FC–12

CONTACT: (202) 225–1721

Thomas Announces Request for Written Comments on H.R. 3376, the "Tax Technical Corrections Act of 2005"

Congressman Bill Thomas (R–CA), Chairman of the Committee on Ways and Means, today announced that the Committee is requesting written public comments for the record from all parties interested on H.R. 3376, the "Tax Technical Corrections Act of 2005."

BACKGROUND:

On Thursday, July 22, 2005, Chairman Bill Thomas introduced H.R. 3376, the "Tax Technical Corrections Act of 2005." The legislation contains technical corrections needed with respect to recently enacted tax legislation.

"We hope the public will review the proposed text and provide comments during the coming weeks on any amendments that may be necessary so that Congress can send appropriate legislation to the President as soon as possible," stated Thomas.

The bill includes technical corrections to provisions in the "American Jobs Creation Act of 2005" (P.L. 108–357), and other legislation.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit for the record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, *http://waysandmeans.house.gov*, select "*109th Congress*" from the menu entitled, "*Hearing Archives*" (*http://waysandmeans.house.gov/Hearings.asp?congress=16*). Select the request for written comments for which you would like to submit, and click on the link entitled, "*Click here to provide a submission for the record.*" Once you have followed the online instructions, completing all informational forms and clicking "submit" on the final page, an email will be sent to the address which you supply confirming your interest in providing a submission for the record. You ***MUST REPLY*** to the email and ***ATTACH*** your submission as a Word or WordPerfect document, in compliance with the formatting requirements listed below, by close of business Wednesday, August 31, 2005. **Finally**, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225–1721.

FORMATTING REQUIREMENTS:

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee.

The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All submissions and supplementary materials must be provided in Word or WordPerfect format and MUST NOT exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. All submissions must include a list of all clients, persons, and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone and fax numbers of each witness.

Note: All Committee advisories and news releases are available on the World Wide Web at *http://waysandmeans.house.gov*.

Accenture
Palo Alto, California 94304
August 31, 2005

The Honorable Charles Grassley
Chairman
Senate Finance Committee
219 Dirksen Office Building
Washington, DC 20510

The Honorable Max Baucus
Ranking Member
Senate Finance Committee
511 Hart Office Building
Washington, DC 20510

The Honorable Bill Thomas
Chairman
House Ways and Means Committee
1102 Longworth Office Building
Washington, DC 20515

The Honorable Charlie Rangel
Ranking Member
House Ways and Means Committee
2354 Rayburn Office Building
Washington, DC 20515

Dear Chairmen Grassley and Thomas and Ranking Members Baucus and Rangel:

On behalf of Accenture and its 120,000 employees, including the 28,000 U.S. employees of Accenture LLP, we thank you for the opportunity to comment on recently introduced legislation, the Tax Technical Corrections Act of 2005, pursuant to your press release of August 8, 2005.

As we have discussed with you and your staff, the "corporate inversion" provisions as passed in the Jobs Creation Act of 2004 are broad in their scope. Accordingly, it could potentially lead to the unintended application of the law to the transactions of a foreign multinational company. Without further guidance or clarification, taxpayers cannot be certain regarding a company's status under section 7874. Now, more than ever, public companies need certainty. Although we believe that we are not impacted by the statute, we urge Congress to provide a technical correction to provide greater certainty.

It is important to emphasize that Accenture did not engage in an inversion transaction.

- Prior to May 2001, Accenture operated as a series of separate legal entities organized under the laws of more than 40 countries, including the U.S. Accenture, as a multinational enterprise, has never operated under a U.S. parent corporation or partnership.
- In May 2001, Accenture completed the transaction in which the owners of U.S. and non-U.S. businesses each combined the separate locally owned businesses into one global corporate structure.
- In July 2001, Accenture successfully completed an initial public offering.
- Accenture did not engage in an inversion by moving its place of incorporation from the U.S. to Bermuda. The U.S. General Accounting Office (GAO) confirms this. A GAO report in October 2002 did not include Accenture on a list of government contractors that undertook corporate inversions. In media coverage of the report, the GAO's Director of Tax Issues, James White, said: "Since Accenture didn't have a corporate structure to begin with, it didn't have a corporate structure to invert." The GAO report provides a brief history of Accenture's pre-incorporation operation, explaining that Accenture was a series of locally owned partnerships coordinated through a Swiss entity.
- Accenture pays, and has always paid, tax in each of the countries in which we generate income. Accenture LLP pays U.S. tax on income generated by our U.S. operations, and the appropriate entities pay tax on non-U.S. income in the countries in which that income is generated. In fact, Accenture's annual effective tax rate as disclosed in its Securities and Exchange Commission (SEC) filings is high compared to those of most companies. As reported in our most recent 10K, our annual effective tax rate for the fiscal year ending August 31, 2004 was 32%.

Although Accenture did not engage in an inversion transaction, the broad scope of the JOBS Act continues to create uncertainty.

- Along with many other companies and commentators, we have previously expressed our concerns regarding the legislation's broad scope and its potential for misapplication to the various types of restructurings of foreign multinational companies.
- While transactions before March 4, 2003, and internal restructurings are not among the transactions that the legislation was apparently intended to target, a taxpayer cannot be certain given the breadth of the statute.
- The broad reach of the legislation is particularly a concern to taxpayers where the legislation applies to a transaction that was completed before March 4, 2003. As a result, every multinational company must examine past transactions to determine if the legislation applies.
- The consequence to taxpayers of an unclear statute is, for example, as reflected in our most recent 10K filing: "We do not believe this legislation applies to Accenture. However, we are not able to predict with certainty whether the U.S. Internal Revenue Service will challenge our interpretation of the legislation. Nor are we able to predict with certainty the impact of regulations or other interpretations that might be issued related to this legislation. It is possible that certain interpretations could materially increase our tax burden." The consequence of inappropriate or retroactive application is to impose on non-U.S. operating income a U.S. income tax burden that neither the multinational company nor the investment community could or should have anticipated.

We as taxpayers, and our shareholders, need greater certainty. We believe that by clarifying the proper scope of the legislation through technical corrections legislation and guidance, Congress would be providing the greater certainty that is appropriate in today's environment.

We appreciate having the opportunity to provide our views on this important matter.

Douglas G. Scrivner
General Counsel and Secretary

AEGON USA, Inc.
Washington, DC 20515
August 19, 2005

The Honorable William Thomas, Chairman
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515–6348

Dear Chairman Thomas,

On behalf of AEGON USA, I am writing to comment on the proposed legislation to make technical changes in the tax code, H.R. 3376, the *Tax Technical Corrections Act of 2005*. I appreciate the opportunity to raise the following points with the Ways and Means Committee about the potential inclusion of an additional technical correction related to the identified straddle amendments included in H.R. 4520, the *American Jobs Creation Act of 2004 (the "Act")*.

The specific concern with this provision is that it could be interpreted so as to result in a permanent disallowance of a loss rather than a loss deferral. In addition, there is some question as to the effectiveness of the provision prior to the promulgation of guidance by the Secretary. Based on discussions with the staff of the Ways and Means Committee, Finance Committee and Joint Committee of Taxation, as well as with Treasury Department personnel, it does not appear that the intent of the new provision was to eliminate losses altogether or to delay the effective date of the new rules until regulations are issued. As a result, we ask you to consider making technical corrections to this provision to ensure it operates as intended.

Background

Included in the Act was a provision revising the existing rules on straddles, including a reform that was viewed as simplifying the law for so-called identified straddles. To avoid abuses, the general straddle rules require a taxpayer to defer losses incurred until gains in offsetting positions are realized. Previous law provided an exception to this rule for certain identified straddles. The new statutory language replaced this exception with a basis adjustment rule and appeared to provide more flexibility for taxpayers to use identified straddles. This new provision is of interest to AEGON USA and other insurers because, as insurance companies, we are in the business of managing risks, including investment risks. We frequently enter into offsetting positions in the ordinary course of our business to conservatively manage such risks. As a result, we have transactions that could be subject to the general straddle rules, absent the ability to use alternatives such as identified straddles.[1]

The legislation passed last year was initially viewed by us and others in the insurance industry as a welcome clarification and simplification of the identified straddle rules. Unfortunately, recent comments by Treasury and IRS personnel have suggested an interpretation outside the apparent intent of Congress. As noted above, their interpretation is that the new statutory language might result in the permanent denial of a loss, rather than loss deferral. Such a dramatic change in the straddle rules is not discussed in any of the legislative history, nor does it fit with the simplification and clarification theme of the provision.

Moreover, taxpayers who wish to use the identified straddle regime need clarification that, until the Treasury Department issues regulations, they may use reasonable methods to identify straddles. Congress enacted the new identified straddle rules effective October 22, 2004, and taxpayers should not be forced to wait for Treasury to issue regulations before being able to utilize the new rules.

It seems that these two issues should appropriately be addressed in a technical corrections bill to ensure that the provision operates as intended.

Identified Straddle Exception—Losses in Excess of Unrecognized Gains

The tax straddle rules (IRC section 1092) generally require taxpayers to defer realized losses on a straddle position to the extent the taxpayer has unrecognized gains on offsetting straddle positions. Losses in excess of unrecognized gains, however, are not limited by the straddle rules. In addition, losses that are deferred under the straddle rules can be carried forward indefinitely and become available to the taxpayer in a future year to the extent such deferred losses exceed unrecog-

[1] There are other potential exceptions to the straddle rules, such as the tax hedging rules of IRC section 1221(a)(7) or other hedging provisions (Treas. Reg. section 1.988–5 and Treas. Reg. section 1.1275–6). However, these hedging exceptions are narrowly drawn and are not always available to an insurance company with a large, actively managed investment portfolio.

nized gains on offsetting straddle positions. This can occur, for example, when gains on an offsetting straddle position are recognized upon a subsequent sale of the offsetting position.

Although the basic goal of the straddle rules can be easily described, application of the rules can be problematic. The straddle rules are written in a manner that assumes that the offsetting positions in a tax straddle are readily determinable. While this may be true for an investor with a limited number of positions, determining the positions that make up a tax straddle is a difficult and uncertain proposition for a taxpayer, such as an insurance company, holding and managing a large investment portfolio in the ordinary course of its business. When the tax straddle rules were originally enacted in 1981, Congress directed the Secretary to promulgate guidance providing a method to be used by taxpayers in the determination of the positions making up a tax straddle. No such guidance, however, was ever provided by the Secretary.

Section 888 of the Act significantly extended the availability of the prior law exception for qualifying "identified straddles." The amendments made by the Act reflect Congress' frustration with the failure of the Secretary to provide required guidance on the application of the straddle rules to "unbalanced" straddle positions, which the Secretary had been instructed to provide under the original straddle legislation adopted in 1981.[2]

Under the new "identified straddle" rules, taxpayers are allowed to identify the offsetting positions making up the straddle. The positions making up an identified straddle are then excepted from the general straddle loss deferral rules, and are instead subject to the special rules for identified straddles. The identified straddle rules are important in providing taxpayers some certainty over the positions making up a tax straddle, thereby precluding such identified positions from being arbitrarily considered a tax straddle with respect to other positions on an after-the-fact basis.

In addition to exempting the offsetting positions of an identified straddle from the general straddle loss deferral rules, the new identified straddle rules also provide that realized losses from any position included in an identified straddle are added to the tax basis of those offsetting identified positions with "unrecognized gain," but only to the extent of the amount of such unrecognized gain. For purposes of the identified straddle rules, "unrecognized gain" is defined as the excess (if any) of (1) the fair market value of a position as of the date a loss on an offsetting position in the identified straddle is realized (the "determination date") over (2) the fair market value of the position on the date the identified straddle was entered into. Realized losses that are added to the tax basis of an offsetting identified straddle position are essentially deferred until the offsetting position is subsequently disposed of. Losses in excess of "unrecognized gains" are exempt from the straddle rules.

Notwithstanding what appears to be clear Congressional intent to provide an exception to the straddle rules for qualifying identified straddles, the amendments made by the Act could be construed in a manner that would permanently disallow realized losses on offsetting positions in an identified straddle. Specifically, IRC section 1092(a)(2)(A)(ii) requires that the tax basis of each of the identified offsetting positions in the identified straddle be increased "by an amount that bears the same ratio to the loss as the unrecognized gain with respect to such offsetting position bears to the aggregate unrecognized gain with respect to all such offsetting positions." IRC section 1092(a)(2)(A)(iii) then states that "any loss described in clause (ii) *shall not otherwise be taken into account* for purposes of this title." (*Emphasis added*.)

It seems clear that the "not otherwise taken into account" reference in IRC section 1092(a)(2)(A)(iii) was simply intended to prevent taxpayers from attempting to "double dip" or utilize the same loss twice. In other words, to the extent any portion of a realized loss is added to the tax basis of an offsetting position included in an identified straddle, that portion of the loss would not otherwise be deductible. The legislative history to the Act confirms this intent by stating that any loss with respect to an identified position that is part of an identified straddle "cannot otherwise be

[2] In 2001, in a study of simplification alternatives for the tax code, the Joint Committee on Taxation proposed several changes to the straddle rules including what we believe is the first version of a proposal to statutorily clarify the identified straddle regime; a proposal that was ultimately enacted as Section 888 of the *American Jobs Creation Act of 2004* (P.L. 108–357). In the discussion by the Joint Committee on Taxation, the staff noted that the Treasury Department had not issued regulations since 1981, when Congress had directed Treasury to issue regulations related to identified straddles and unbalanced straddles. The staff recommended a new identification regime as well as a capitalization regime that ultimately was included in the *American Jobs Creation Act of 2004* (Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS–3–02), pp. 339–342).

taken into account by the taxpayer or any other person *to the extent that the loss increases the basis of any identified positions that offset the loss position* in the identified straddle." (*Emphasis added*.)

Notwithstanding this logical interpretation, some Administration personnel have publicly stated that the modified identified straddle rules can be interpreted to cause permanent denial of a portion of a taxpayer's realized losses on positions included in an identified straddle—a result that is contrary to both the normal straddle loss deferral rules, as well as to the exception provided for qualifying identified straddles. If such an interpretation were correct, the modified identified straddle rules would actually result in a dramatic shift in policy from deferring losses to permanently denying losses. This would mean that an amendment that was intended to provide taxpayers with relief from the general straddle rules would instead result in identified straddles being subjected to more onerous rules. This potential interpretation of the identified straddle rules, however remote, makes the modified identified straddle rules a potential tax trap.

Technical corrections to the amended identified straddle rules are necessary to make it clear that realized losses resulting from an offsetting position in an identified straddle that exceed unrecognized gains on other positions included in the identified straddle do not disappear, but are available in the year realized.

Example of Losses in Excess of Unrecognized Gains

Because a straddle involves "offsetting positions," one might wonder why a loss on one position would not be offset by unrecognized gain in the other position. It is possible, however, for an identified straddle to have a result in which there is no unrecognized gain on an offsetting position. Such a result may occur, for example, when an unrelated risk that is not offset causes the value in the offsetting position to decrease.

For example:

In the ordinary course of its business, an insurance company buys a corporate bond for $95 to back its insurance liabilities. Because the company is concerned that interest rates will rise, it also enters into an interest rate swap to hedge this risk. Assume that the company properly and timely identified the bond and the swap as the positions making up an "identified straddle" under new IRC § 1092(a)(2).

If interest rates rise, the bond market value may drop to $92, but the swap will be worth $3. If interest rates fall, the bond market value may increase to $97, but the swap will be worth ($2). In both situations, the company is economically in the same position. If the swap were to be sold in the first instance, a $3 gain would be recognized. Under the new identified straddle rule, if the swap were to be sold in the second instance, the basis of the bond would be increased by the $2 realized loss on the swap.

However, assume that interest rates fall as in the second scenario and that the bond's credit rating also is downgraded. Assume that as a result of these events, the bond's market value falls to $80, while the swap value is ($2). If the swap were to be sold in this situation, the treatment of the $2 realized loss is not clear under the new statutory language because the loss exceeds the amount of unrecognized gain (which is $0) on the offsetting position.

Under the Administration's potential interpretation of the new identified straddle language, the taxpayer in the above example would be permanently denied the $2 true economic loss on the swap if there is not an equal amount of unrecognized gain on the offsetting bond. It appears obvious that this result is not appropriate and was not intended as part of the amendments to IRC § 1092(a)(2).

Technical Correction Needed

Our concerns about the identified straddle language result from public comments made by both Treasury and IRS officials who have stated that a literal interpretation of the new language could result in loss denial rather than loss deferral. One of the same Treasury officials also indicated that clarifying the operation of this provision might not be possible by way of regulations, noting that "[f]rankly I don't know how we in the administration would correct that." ("Officials Cite Problems with Changes to the Straddle Rules," Tax Notes, June 6, 2005, p. 1229–30). The clear implication is that the statute must be corrected by a technical correction.

Representatives from AEGON USA have met with the Joint Committee on Taxation and the respective staffs of the tax writing committees. At this stage, no one has suggested that Congress had intended (in the straddle language adopted) to deny losses completely. The legislative history does not suggest such an outcome either. As such, we believe that this issue is appropriate for a technical correction to clarify the application of the new identified straddle provision in cases where losses from an identified straddle position exceed unrecognized gains on identified offsetting positions.

The legislative history clearly supports the conclusion that Congress did not intend to deny losses as is illustrated in the example above. Further, as noted above, the relevant legislative history indicates that losses in excess of unrecognized gains may be taken immediately, by stating that "Any loss with respect to an identified position that is part of an identified straddle cannot otherwise be taken into account by the taxpayer or any other person *to the extent that the loss increases the basis of any identified positions that offset the loss position in the identified straddle*." (H. Rpt. 108–755, American Jobs Creation Act of 2004, Conference Report to Accompany H.R. 4520, pp. 756–57) (emphasis added). To the extent the losses in the example set out above do not increase the basis of any identified offsetting positions in the straddle, the reasonable interpretation of the new statutory language and the relevant legislative history is that the taxpayer should be able to immediately deduct such a loss. This legislative history is repeated in the Blue Book for the 108th Congress. (Joint Committee on Taxation, "General Explanation of Tax Legislation Enacted in the 108th Congress" (JCS–5–05), May 2005, p. 484).

Identified Straddle Exception—Effectiveness

Finally, Treasury officials have also suggested that the new identified straddle provisions do not take effect unless and until the Secretary prescribes regulations specifying, among other items, the proper methods for clearly identifying a straddle as part of an identified straddle.

The Administration's suggestion that the new identified straddle rules are not effective unless and until regulations are promulgated by the Secretary does not appear to have any support in the statute itself or the accompanying legislative history. This interpretation also seems wholly inconsistent with the rationale for amending IRC section 1092(a)(2) itself, namely the failure of the Secretary to have prescribed regulations pursuant to the 1981 legislative mandate obligating the Secretary to establish guidance for unbalanced straddle positions.

The Joint Committee on Taxation, in explaining the reasons why the identified straddle rules were changed, states "While the prior-law rules provided authority for the Secretary to issue guidance concerning unbalanced straddles, the Congress was of the view that such guidance was not forthcoming. Therefore, the Congress believed that it was necessary to provide such guidance by statute." (Joint Committee on Taxation, "General Explanation of Tax Legislation Enacted in the 108th Congress" (JCS–5–05), May 2005, p. 483). In fact, Treasury has had the opportunity to issue regulations for nearly 23 years, and it has chosen not to do so. It may take significant time for any such future guidance from Treasury. The statute's language, on its face, applies to positions established on or after October 22, 2004. Therefore, we suggest a technical correction making it clear that a taxpayer can use a reasonable method to identify the positions making up an "identified straddle" until such time as the Treasury issues regulations under IRC section 1092(a)(2).

Proposed Technical Corrections

We respectfully submit the attached technical correction language as a proposal that would ensure that the new identified straddle provision operates as intended and cannot be interpreted to permanently deny realized losses that exceed unrecognized gains.

The suggested language in subclause I is drawn directly from the legislative history. (See, *e.g.*, H. Rpt. 108–755, American Jobs Creation Act of 2004, Conference Report to Accompany H.R. 4520, p. 756). We believe this approach—which confirms that losses from identified straddle positions that exceed unrecognized gains on offsetting positions are available in the year realized—is supported by the legislative history and a fair reading of the statute.

Alternatively if the Committee determines that the intent of the modified identified straddle rules was to parallel the general straddle loss deferral rule, a second option would be to capitalize all losses realized on positions included in an identified straddle, not just losses up to the amount of "unrecognized gain" on offsetting positions. We could support an interpretation that requires capitalization of the full amount of realized losses on positions included in an identified straddle since this alternative would at least provide taxpayers with assurances as to the positions making up a tax straddle. This clarification would in and of itself be valuable in that it would provide taxpayers with certainty as to the operation of the straddle rules and, as a result of the basis adjustments to offsetting positions, the time at which losses would eventually be made available. The attached proposed technical correction does not reflect such a broad policy change and, if this approach were adopted, further revisions to the proposed technical correction to IRC section 1092(a)(2) would be required.

We also suggest a clarification to explicitly allow taxpayers to use any reasonable method to identify straddles unless and until the Treasury issues regulations.

Conclusion

Thank you for the opportunity to comment on the H.R. 3376, the *Tax Technical Corrections Act of 2005*. I hope you will look favorably on including the requested technical corrections in the legislation.

Arthur C. Schneider
Senior Vice President and Chief Tax Officer

Alticor Global Holdings, Inc.
Washington, DC 20001
August 31, 2005

House Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

To whom it may concern:

In response to the request for additional technical corrections dated July 21, 2005, we would like to submit, on behalf of our client Alticor Global Holdings Inc., the following request regarding the treatment of wholly owned partnerships under new section 199. The recently introduced technical corrections bill (H.R. 3376/S. 1447) adds a provision that generally would treat a partnership and the members of an expanded affiliated group (EAG) as a single taxpayer (for purposes of determining domestic production gross receipts) where the partnership is owned entirely by members of the EAG. For the reasons described below, we respectfully request that a similar rule be applied to situations where a partnership is wholly owned by entities that, in turn, are owned entirely by a common parent. We see no policy reason to distinguish between the two situations.

Applicable Facts

Alticor Global Holdings Inc. (AGHI) is a U.S. S corporation. It is the common parent of several entities that are collectively engaged in the business of manufacturing and selling a wide range of consumer products. These products are sold in more than 60 countries under trademarks and trade names owned by AGHI and its affiliates. AGHI owns indirectly 100 percent of Alticor Enterprises Inc. (AEI), which, in turn, is the common parent of Alticor Distribution Inc. (ADI) and Access Business Group LLC (ABGL). AGHI intends to elect to treat AEI and ADI as "qualified subchapter S subsidiaries." ABGL is a subchapter C corporation.

ADI and ABGL collectively own 100 percent of Access Business Group International LLC (ABGIL), a Delaware limited liability company that is treated as a partnership for Federal tax purposes. ABGIL was formed as a partnership rather than as a corporation for local law purposes. (A diagram of this corporate structure is attached to this letter.)

ABGIL owns title to the manufacturing intangibles for most of the products produced by the group. It also performs the research and development for the group. ABGIL does not itself manufacture the products it distributes, but rather contracts with ABGL, the group's manufacturer, to produce the products. Under the contracts, ABGL has the right to use ABGIL's manufacturing intangibles and to affix ABGIL's trademarks and trade names to the products. The products are manufactured entirely in the United States.

Section 199

Section 199 was enacted under the American Jobs Creation Act of 2004 to encourage the domestic production of goods and to help replace the export tax incentives. In general, Section 199 effectively provides taxpayers with a deduction for a portion of their income derived from property manufactured or produced "by the taxpayer in whole or significant part within the United States."

To fully encourage domestic production, Congress has evinced a policy that integrated producers should be able to treat both their production income and their distribution income as subject to Section 199. This is true regardless of whether the distribution activity takes place in the same entity as the production function, or is undertaken by a related party. For example, by providing that the members of an EAG are treated as a single taxpayer, Congress clearly intended that the Section 199 production incentive apply to both the production income and the distribution income of an integrated group. Similarly, the example in the legislative history regarding the roasting of coffee beans also indicates that distribution income qualifies for the benefit of Section 199 in the case of an integrated producer. Finally, the recently introduced technical corrections bill provides that a partnership and the members of an EAG will be treated as a single taxpayer if the partnership is wholly-owned for its entire taxable year by the members of the EAG. Thus, if the partnership distributes products produced by members of the EAG, the technical correction would allow both the production income derived by members of the EAG and the distribution income derived by the partnership to qualify for the benefits of Section 199.

It is also important to note that tax incentives under both the Foreign Sales Corporation regime and the Extraterritorial Income regime would apply to the distribution income of an integrated production group. Section 199 was a replacement for these two regimes and the statutory scheme is similar in many respects.

The failure to adopt our requested technical correction may cause anomalous results and provide some wholly owned corporate groups with a competitive advantage over others. For example, distributor A is a partnership owned by two C corporations, both of which are members of the same EAG. One of A's corporate partners manufactures all of A's products in the United States. Distributor B is a major competitor of distributor A. Distributor B is a partnership that is owned by a QSS and a C corporation, both of which are wholly owned by a common parent S corporation. The C corporation partner manufactures all of B's products in the United States. A and B both own all of the manufacturing intangibles related to the production of their respective group's products.

In the case of distributor A, both the production income earned by A's corporate affiliate and the distribution income earned by A would qualify as QPAI under the recently introduced technical corrections bill (because the partnership and the members of the EAG would be treated as a single taxpayer). By contrast, in the case of distributor B, the manufacturing income earned by B's corporate affiliate may not qualify as QPAI (under the benefits and burdens test of Notice 2005–14). Obviously, if B were denied similar treatment to A, it would provide A (and its corporate affiliates) a significant competitive advantage over B (and its corporate affiliates). As with A, both the production income and the distribution income derived by B and its corporate affiliates should be eligible for treatment as QPAI.

Requested Technical Correction

In light of the foregoing issues, we respectfully request that a technical correction be adopted clarifying the application of section 199 to situations where a partnership is wholly owned by entities that, in turn, are owned entirely by a common parent. We suggest that either of the following two alternatives would properly address our issues. We believe either change is consistent with the legislative policy underlying section 199.

Option 1

For purposes of determining domestic production gross receipts, if a group of entities are wholly owned (directly or indirectly) by a common parent corporation during the entire taxable year of such parent corporation, each such entity and the common parent corporation shall be treated as a single taxpayer.

Option 2

The definition of "expanded affiliated group" in section 199 could be amended to include S corporations by modifying the language of section 199(d)(4)(B)(ii) to read as follows: "without regard to paragraphs (2), (4), and (8) of section 1504(b)."

We very much appreciate the opportunity to submit our comments regarding proposed technical corrections. We would be happy to meet with you to discuss these issues further. Also, if you have any questions or need additional information, please call either of us.

Linda Carlisle
White & Case

Jonathan Talisman
Capitol Tax Partners

Statement of Kevin M. Burke, American Apparel & Footwear Association, Arlington, Virginia

On behalf of the American Apparel & Footwear Association (AAFA), I am pleased to submit comments to the Committee on Ways and Means regarding some of the undefined issues contained in the American Jobs Creation Act of 2004, P.L. 108–357. AAFA is the national trade association representing over 400 companies in apparel, footwear and other sewn products companies, and their suppliers. AAFA members include American companies that produce clothing, footwear, textile inputs, and related equipment in the United States and around the world. Many of our domestic manufacturing members specialize in supplying sewn products to the military. Our motto, "We Dress the World," accurately portrays the market our members represent, on the commercial side and the military.

AAFA previously submitted comments to the Department of Treasury regarding the promotion of two key points for consideration in Treasury's interpretation of P.L. 108–357. Unfortunately, the Treasury did not agree with AAFA's position on these issues; therefore, it is up to the Committee to effect any change in the Treasury's current interpretation.

Our main area of focus was having domestic contract manufacturing arrangements considered as separate qualifying production activities for the purposes of the manufacturing tax deduction. As design/development is an integral part of the manufacturing process for apparel and footwear production, it is our position that companies investing in this domestic production should also benefit from the manufacturing tax deduction proportional to the amount of production completed domestically.

H.R. 3376 does not currently address either of the issues important to AAFA. On behalf of our members I urge the committee to consider providing Treasury with additional direction in these areas so that small businesses that engage primarily in subcontracting and multinational companies that perform their design and development domestically can also benefit from these changes in the tax code. Under the current interpretation of the Department of Treasury, contract manufacturing is not eligible for the deduction as only the taxpayer owning the tangible property during the manufacturing process is considered the manufacturer.

Contract Manufacturing

Both domestic and multinational companies routinely contract portions of the manufacturing process to other companies. Recognizing domestic contract manufacturing arrangements as part of the manufacturing process is paramount for apparel and footwear companies and especially for the smaller companies as subcontract jobs can make up a significant part of their business. Many AAFA domestic manufacturers regularly accept subcontracts from larger companies and also subcontract portions of the highly competitive government contracts.

Government contracts for apparel and footwear, as with other industries, typically span several years. The difficulties of accurately predicting long-term work flow, the rise and fall of demand and cost of supplier components among other factors, can contribute to an overload on occasion. Rather than forfeit a contract, any company will attempt to subcontract a portion of the original contract. In addition, in most manufacturing processes and businesses, in order to remain competitive, develop niche markets and specialized expertise. This fosters an atmosphere ripe for subcontracting specific portions of a program. There may be one or only a few companies that have the capabilities to perform certain functions in the apparel and footwear manufacturing process and thus contributing to the additional demand for subcontracting particular portions.

Under current U.S. Code 26 Section 263A, production or the term produce "includes construct, build, install, manufacture, develop, or improve." Also under this section, "the taxpayer shall be treated as producing any property produced for the taxpayer under a contract with the taxpayer; except that only costs paid or incurred by the taxpayer (whether under such contract or otherwise) shall be taken into account in applying" direct and indirect costs to the taxpayer. AAFA supports the inclusion of this language in the interpretation of P.L. 108–357, which would allow the producer or taxpayer, including subcontractors, of the apparel and footwear manufacturing process to benefit from the manufacturing tax deduction.

Under P.L. 108–357, the deduction is based on the lesser of the qualified production activities (QPA) income of the taxpayer or taxable income. The qualified production activities income is equal to the excess of the domestic production gross receipts over the sum of (1) the cost of goods sold allocable to such receipts, (2) other deductions, expenses, or losses directly allocable to such receipts and (3) a ratable portion of other deductions, expenses, and losses not directly allocable to such receipts or another class of income. Domestic production gross receipts, as it applies to AAFA members, consists of the receipts for any lease, rental, license, sale, exchange, or other disposition of qualifying production property which was manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States. Qualifying production property as it applies to AAFA members is the tangible personal property—apparel and footwear.

The deduction is based on profit—the cost for producing the item from a subcontract basis is included in the original taxpayer's overall costs. Therefore, the deduction for the original taxpayer is not for the same profit received by the subcontractor to make a portion of the product. This allows for both the subcontractor and original taxpayer to take advantage of the deduction. AAFA supports separately computed deductions for the original taxpayer and the contractor.

Design and Development

An essential part of the process for manufacturers of apparel and footwear and for most manufacturing is design and development. The process of producing a design and parlaying that design into a sample product is the beginning of the manufacturing process. In most instances, without the design and development, there would be no production. Many U.S. apparel and footwear companies complete all of the design and development in the U.S. and under the current interpretation of Treasury, packaging, design, and development are not included in the consideration for the application of the "significant part" test for the purposes of determining tangible personal property.

As the face of apparel and footwear manufacturing continues to evolve due to the removal of quotas worldwide on January 1, 2005, the current practice of completing the design and development in the U.S. may change. Companies are consolidating their sourcing in fewer countries and with the advent of manufacturing cities, which include every component in the manufacturing process in one location—from the supply of yarn, fabric, thread, buttons, zippers, cutting and sewing, what is there to keep this part of the process in the U.S. Due to this type of sweeping transformation in the way apparel and footwear companies do business, an incentive to keep the design and development in the U.S. could not come at a better time. The manufacturing deduction would serve as incentive for companies to continue to make a substantive investment in the people and process that make up this important phase of the manufacturing process. The ability to take advantage of a QPA deduction for this part of the manufacturing process will contribute significantly toward keeping this element of the process in the U.S. Therefore, as an integral part of the apparel and footwear manufacturing process, AAFA strongly urges the Committee to consider providing Treasury with more specific direction that would allow companies performing their design and development in the U.S. to benefit from the deduction in P.L. 108–357.

AAFA appreciates the opportunity to comment on the Committee on Ways and Means regarding H.R. 3376. If you have any questions about AAFA's position on any of the above comments, please feel free to contact Felicia Cheek at 703.797.9039.

American Association of Port Authorities
Alexandria, Virginia 22314
August 31, 2005

The Honorable William M. Thomas
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Thomas,

I am writing to you today regarding your request for written comments on H.R. 3376, the "Tax Technical Corrections Act of 2005." Recently, Congressmen Dave Weldon and Christopher Shays introduced H.R. 3319 to amend the IRS Code to exempt domestic intermodal cargo containers and cargo loaded on a vessel by means of wheeled technology from the Harbor Maintenance Tax. The American Association of Port Authorities (AAPA) urges you to include this provision in your technical corrections bill. AAPA represents the leading public port authorities in the Western Hemisphere, and these comments reflect the position of our U.S. members. Most maritime trade that flows in and out of the U.S. transits through AAPA member ports.

As the primary congressional committee dealing with trade, you are well aware of the importance of trade to this nation and the projections for increases in the coming years. Ports are looking strategically at how to accommodate this growth, especially in terms of transporting cargo out of the port facilities in a way that will not overload our current highway and rail transportation systems. Road congestion and projected increases in trade volumes have spurred many in the maritime industry, including the Maritime Administration, to try to encourage the use of short sea shipping to carry some of the domestic load. This industry is well developed in Europe, and maritime transportation is underutilized in the U.S. for domestic shipping.

In the United States, most cargo imported or exported through seaports is transported by truck or rail. Congestion is evident at most large U.S. ports, many of which are also located in heavily congested urban areas. A March 2003 report from the U.S. Chamber of Commerce, *Trade and Transportation: A Study of North American Port and Intermodal Systems*, highlighted this growth in trade and the need to "proactively address the current crisis in the capacity of our intermodal system." Short sea shipping is one part of this solution.

Domestic short sea shipping would also allow this country to accommodate the increase in cargo trade by providing an alternative to the already overburdened highways and railroads. Unfortunately, the Harbor Maintenance Tax has been identified by experts as a cost disincentive to the development of this new industry. Trucking rates and rail rates are very competitive with short sea shipping. Exempting certain domestic cargo from the Harbor Maintenance Tax would encourage the expansion of short sea shipping.

Established in 1986, the Harbor Maintenance Tax (HMT) is an *ad valorem* tax on the value of commercial cargo. The tax is deposited into a trust fund to pay 100% of maintenance dredging of harbors, which is conducted by the U.S. Army Corps of Engineers. Unfortunately, Congress has not allowed full use of this trust fund, and there is currently a surplus of $2.6 billion.

There are currently several exemptions from the HMT, and we hope your committee will endorse an additional exemption for certain intermodal cargo shipped on coastal routes or rivers between U.S. ports as outlined in H.R. 3319. The current law excludes ferries, cargo moving to and from Alaska and Hawaii other than Alaskan crude oil, and any cargo associated with vessel movements to and from most of the inland waterways system. We are not encouraging a full domestic exemption, only a tax law change that would impact containerized cargo and cargo loaded on vessels by means of wheeled technology. Bulk cargos would not be exempt, since much of this type of cargo already uses the maritime system heavily.

As with any tax change, it is important to consider the cost. Preliminary estimates put the cost of this new exemption at under $2 million a year. The Corps of Engineers reports that for FY'02 (the most recent report on the Harbor Maintenance Trust Fund) the total of all HMT domestic payments was $28 million. Also, total domestic cargo was only 4.3% of the total HMT collected in 2002. This provision would only be a small subset of the domestic total. With a $2.6 billion surplus in the trust fund that continues to grow each year, adding this exemption to the law would not harm the trust fund.

Short sea shipping is an exciting opportunity that shows great promise for helping the U.S. address the cargo congestion brought on by growth of trade in this country. By recommending a change in the tax law to provide an additional exemption for certain domestic cargos, your committee would be doing a great service to this nation by promoting the transportation solutions for tomorrow.

The American Association of Port Authorities thanks you for your consideration of this important maritime issue and would be very interested in discussing this matter further as you develop changes to the Tax Technical Corrections Act of 2005.

Kurt J. Nagle
President

American Bankers Association
Washington, DC 20036
August 30, 2005

The Honorable William M. Thomas
Chairman
House Ways and Means Committee
Washington, DC 20515

Dear Chairman Thomas:

The undersigned banking trade associations offer our support for the Technical Tax Corrections Act of 2005 (H.R. 3376 and S. 1447). Late last year, the enactment of the American Jobs Creation Act of 2004 ("AJCA") provided many positive and pro-growth tax reforms, including significant Subchapter S Corporation reforms. Fortunately, the Technical Tax Corrections Act of 2005 will ensure that provisions included in AJCA can be properly implemented as intended by Congress. We support this important effort and urge lawmakers to quickly pass the Technical Tax Corrections Act as introduced.

We are especially pleased to see that the Technical Tax Corrections Act of 2005 includes several needed technical corrections to the S Corporation reforms included in the AJCA.

Specifically, the Technical Tax Corrections Act helps clarify that eligible Subchapter S shareholders include IRAs holding stock in a bank, bank holding company, or thrift holding company. The legislation will also make clear that the scope of the passive income exemption provision encompasses thrift holding companies. Moreover, important language is included that will clarify that a qualified Subchapter S subsidiary is a separate entity for purposes of information returns. This legislation will also ensure that the estate of a family member is treated as a member of the family for purposes of determining the number of shareholders. Finally this measure will verify that eligible adopted and foster children will be treated as "lineal descendants" or "common ancestors" in the definition of "members of the family" in the tax code.

These crucial technical corrections to the Subchapter S reforms in the AJCA will provide our membership with much-needed clarity. We appreciate your efforts and urge speedy passage of this important legislation.

Ed Yingling
President and CEO

Diane Casey-Landry
President and CEO of America's Community Bankers

Camden R. Fine
President and CEO of Independent Community Bankers of America

American Council of Engineering Companies
Washington, DC 20005
August 31, 2005

The American Council of Engineering Companies (ACEC) submits these comments in regard to the Tax Technical Corrections Act of 2005. ACEC is the business association of America's engineering industry, representing approximately 5,500 independent engineering companies throughout the United States engaged in the development of America's transportation, environmental, industrial, and other infrastructure. ACEC thanks the Ways and Means Committee for their work to ensure that the implementation of the American Jobs Creation Act (P.L. 108–357) is carried out smoothly and to solicit the input of the regulated community on this process.

Definition of Engineering

The proposed definition in the Notice for "engineering and architectural services" is consistent with IRS Regulation Section 1.924(a)–1T(e)(5) and –1T(e)(6):

(b) Engineering services. Engineering services in connection with any construction project include any professional services requiring engineering education, training, and experience and the application of special knowledge of the mathematical, physical, or engineering sciences to those professional services such as consultation, investigation, evaluation, planning, design, or responsible supervision of construction for the purpose of assuring compliance with plans, specifications, and design.

While this definition is consistent with previous relevant IRS definitions, it could be interpreted to exclude engineering services that are related to a construction project, but occur after construction is completed. ACEC suggests Congress include in the Tax Technical Correction Act language to amend the definition to:

(b) Engineering services. Engineering services in connection with any construction project include any professional services requiring engineering education, training, and experience and the application of special knowledge of the mathematical, physical, or engineering sciences to those professional services such as consultation, investigation, evaluation, planning, design, responsible supervision of construction for the purpose of assuring compliance with plans, specifications, and design ***or the inspection of the constructed facilities after construction***.

This amended definition would clarify that projects like bridge inspections and other post-construction engineering studies, evaluations and audits would qualify for the deduction. These engineering services are crucial to ensuring the safety of construction projects.

Accounting Burden

Engineering firms undertake an enormous volume of projects in a given year. For our larger firms, the contracts associated with engineering and construction/construction management annually number in the thousands, and the projects associated with those contracts would be more than ten-thousand for any given year. Additionally, projects are further broken down into task and sub-tasks, significantly expanding the level of detail. These facts are consistent throughout the architectural and engineering industry.

The IRS Notice on Section 199 requires that the determination of Qualified Production Activities Income be:

"On an item-by-item basis (and not, for example, on a division-by-division, product line-by-product line, or transaction-by-transaction basis) and is the sum of QPAI derived by the taxpayer from each item."

The Notice also states that (**emphasis added**):

"The Engineering or architectural services must relate to real property, must be performed in the United States, and the taxpayer providing these services must be able to ***substantiate*** *that the services relate to a construction project within the United States."*

ACEC believes that the rigorous requirements for determining QPAI "*on an item-by-item basis*" will impose a substantial and unreasonable burden to taxpayers which will overwhelm tax departments and result in firms not taking advantage of the tax treatment that they are entitled to. The "item-by-item basis" could result in each invoice and job scope needing to be reviewed in order to determine whether the Section 199 requirements are met.

ACEC requests that Congress include in the Tax Technical Corrections Act an instruction to the IRS and the Treasury to examine methods that would reduce the accounting burden for engineering firms who are affected by the item-by-item provision. These methods should include the allowance of statistical sampling as already provided in Rev. Procs. 2004–29, 2004–34 and Rev. Proc. 81–70.

Real Property Restriction

ACEC is concerned about troubling and restrictive language that requires that "engineering or architectural services must relate to real property . . ." which was contained in the Tax Technical Corrections Act and also in Treasury Notice 2005–14, the Interim Guidance on Income Attributable to Domestic Production Activities [*hereinafter*, Notice]. The Notice defined real property as "residential and commercial buildings (including items that are structural components of such buildings), inherently permanent structures other than tangible property in the nature of machinery, inherently permanent land improvements, and infrastructure." Also, the Notice defines construction to mean "the construction of real property. . . ." Section 4.04(11). The Notice also states that "tangible personal property (as defined under section 4.04(8)(b)) (for example, appliances, furniture and fixtures) that is sold as part of a construction project is not considered real property for this purpose."

ACEC recommends that the provision requiring that engineering services "must relate to real property" in order to qualify for the tax relief included in the American Jobs Creation Act (P.L. 108–357) should be removed from the Tax Technical Corrections Act and that Congress should instruct the Treasury Department to provide a more inclusive definition for "real property" as related to construction projects. This language, as written, will result in the non-applicability of the provision to engineering work that Congress intended the provision to apply to and will create an undue compliance burden for engineering firms.

The real property restriction in its current form will create difficulties for engineering firms in determining whether they qualify for the benefit. In many cases, an engineering and/or architectural design firm or a construction firm may design or build a project that contains both real and personal property elements. With the many projects that engineering firms undertake each year, the task of determining what percentage of the project fee related to real property and what percentage related to personal property will be extremely complex and will require the firm to expend considerable resources. This may result in many firms not taking advantage of the tax treatment that Congress intended.

In addition to the compliance aspect, certain work that qualified for the export tax deduction under Domestic International Sales Corporation (DISC), the Foreign Sales Corporation (FSC), and the Extraterritorial Income (ETI) would not qualify for the Domestic Production Activities benefit if the proposed real property restriction is included in the final regulation. For example, the design and construction of clean rooms, power plants, steam generating units, and oil refineries would not benefit for the deduction, which was not Congress' intent. Congress intended for this legislation to provide much needed tax relief and to ensure that U.S. business can remain competitive in the global marketplace. The restriction for real property would not fulfill those goals.

ACEC strongly recommends the current language relating to real property should be removed from the Tax Technical Corrections Act and that Congress should instruct the Treasury Department to reconsider their definition of "real property" as related to construction projects in any regulations that are promulgated.

ACEC and our member organizations stand ready to provide you with any additional information necessary to help you implement the American Jobs Creation Act. In addition, we realize that other issues of concern may arise during the implementation of H.R. 4520 and look forward to continuing this dialogue as needed.

Thank you in advance for your consideration of these matters. Please do not hesitate to contact us with any questions.

Danielle Marks
Director, Finance and Regulatory Affairs

American Council of Life Insurers
Washington, DC 20001
August 31, 2005

Mr. Robert Winters
Chief Tax Counsel
Committee on Ways and Means
United States House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Mr. John Buckley
Minority Chief Tax Counsel
Committee on Ways and Means
United States House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Gentlemen:

Attached are the comments of the American Council of Life Insurers regarding a technical correction that we feel is required to section 888(a) of the American Jobs Creation Act of 2005 (P.L. 108–357). The ACLI is the principal trade association of life insurance companies, representing 356 members that account for, in the aggregate, and 80 percent of the assets of legal reserve life insurance companies in the United States.

In the course of conservatively investing company assets for the benefit of their insurance customers, our companies will often engage in hedging transactions to manage interest rate and other risks. Therefore, they are keenly interested in seeing that the changes to Internal Revenue Code section 1092 contained in section 888(a) of the Jobs Act work correctly and clearly reflect Congressional intent. Our comments below explain the issue and our proposed solution.

We appreciate the opportunity to provide our comments and would welcome the opportunity to work with Congressional staff on this issue.

Gregory F. Jenner

Proposed Technical Correction to Section 888(a) of the American Jobs Creation Act

Issue—Section 888(a) of the Jobs Act amended Internal Revenue Code Section 1092(a)(2), which sets forth the tax treatment of identified straddles. Before the Jobs Act amendment, the identified straddle rule provided an exception from the general loss deferral regime applicable to straddles. The new rules now require that if a loss is realized on an identified straddle position, the basis of the remaining offsetting position(s) of the identified straddle shall be increased by the realized loss. The new rules are effective for positions established on or after October 22, 2004.

Importance—Life insurance companies often use hedging techniques to manage interest rate and other risks. Because of this, life insurers may have transactions that could be subject to the general straddle rules (i.e., loss deferral) absent the ability to use narrowly crafted relief provisions such as identified straddles.

Need for Correction—Initially the Jobs Act amendment was viewed as a welcome simplification of the identified straddle rules. The straddle rules are intended to provide a clear reflection of income by deferring loss until gain in offsetting positions is recognized. However, recent comments by Treasury and IRS officials have indicated that the new statutory language could be interpreted to result in a permanent loss denial or a loss deferral in amounts exceeding the losses that would be deferred under the general straddle rules, a result that is contrary to the clear reflection of income principle.

As enacted, the amendments to section 1092(a)(2) appear to assume that, if one position of the identified straddle is disposed of at a loss, there will be gain in the offsetting position. The new rules do not provide what the result will be where there is no gain in the offsetting position. The absence of a specific rule has prompted Treasury and IRS officials to suggest that this may result in a permanent denial of the loss, a result we believe would be entirely inappropriate from a tax policy perspective.

Moreover, where there is insufficient unrecognized gain in the remaining position(s) to offset the entire loss, the new rules appear to result in a deferral of the entire loss, whereas the general straddle rules would permit immediate deduction of the excess loss. Nothing in the legislative history of the provision suggests that Congress intended to enact a more onerous rule than prior law.

Finally, it has been suggested by certain Treasury and IRS officials that regulatory guidance may be required before taxpayers can take advantage of these new rules. While the statute, by its terms, is clearly self-executing, we believe it is essential that this be clarified by Congress in order to prevent frustration of Congressional intent.

Specific Changes—

1. Section 1092 should be amended to specify the treatment of any realized loss on a position in an identified straddle where such loss exceeds the unrecognized gain in the offsetting position(s). One possible approach is to allow the excess loss to be deductible currently. This would be a simple extension of the general straddle rules that defer losses on straddles only to the extent of the unrealized gains in the offsetting positions.
2. If Congress concludes that no loss should be allowed until the offsetting position is disposed of, a rule is still needed under section 1092 to cover situations in which there is no gain in the offsetting position. In those instances, the loss should not be permanently denied. Instead, the loss should be allocated to the basis of the offsetting position so that the loss would be recovered upon disposition of the offsetting position. This could be done in several tax neutral ways, including allocating based on fair market value or basis. We would be happy to work with Congressional staff with respect to this issue.
3. The provision relating to Treasury guidance should be amended to provide that, until such time as there is any such guidance, any reasonable identification method is sufficient. Alternatively, legislative history with respect to the technical corrections bill could provide a similar clarification for taxpayers and regulators.

American Electronics Association
Washington, DC 20004
August 31, 2005

The Honorable William Thomas, Chairman
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Charles Grassley, Chairman
The Honorable Max Baucus, Ranking Minority Member
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairmen Thomas and Grassley and Senator Baucus:

On behalf of AeA (American Electronics Association), I am writing to propose an additional provision be included in the foreign repatriation-related provisions in the Tax Technical Corrections Act of 2005, H.R. 3376 and S. 1447.

AeA is the nation's largest high-tech trade association, representing more than 2,500 member companies that span the high-technology spectrum, from software, semiconductors, and computers to Internet technology, advanced electronics, and telecommunications systems and services. AeA members include small, medium, and large high-tech companies.

Section 965 (often referred to as the "Homeland Investment Act" or "HIA") allows U.S. corporations to elect, for one year only, to claim a dividends received deduction ("HIA DRD") equal to 85 percent of qualifying cash dividends ("HIA dividends") received from controlled foreign corporations ("CFCs"). The HIA DRD allows U.S. corporations to receive HIA dividends subject to a 5.25% effective tax rate, instead of the normal 35% tax rate. HIA is intended to encourage U.S. corporations to repatriate cash from foreign subsidiaries for investment in the United States.

As described below, currently there is uncertainty regarding the portion of a distribution from a CFC that qualifies as a distribution out of earnings and profits ("E&P") attributable to previously taxed income ("PTI") as defined in section 959(c), i.e., the portion of the distribution that is not a dividend. With respect to the year for which the section 965 election is in effect (the "HIA election year"), this uncertainty complicates the calculation of the HIA DRD and therefore discourages maximum repatriations of offshore cash to the United States.

In order to eliminate this uncertainty, a technical correction should provide that the portion of a distribution from a CFC made during the HIA election year ("HIA distribution") which is treated as a PTI distribution will be based on the CFC's undistributed PTI for the most recent taxable year ending on or before June 30, 2003, as reduced by subsequent PTI distributions. This technical correction would be consistent with other provisions of section 965, which provide for computations based on amounts that are fixed prior to the HIA election year.

Issue

There are three components of a distribution under section 965: (1) the distribution of PTI; (2) the base period dividend distribution; and (3) the HIA dividend distribution of deferred earnings. Section 965 currently allows taxpayers to determine with certainty some, but not all, of the material elements of the required calculation. While the statute allows taxpayers to determine the base period amount (as defined in section 965(b)(2)(B)) and the deferred earnings amount (as defined in section 965(b)(1)) with certainty, there is no certainty with respect to the amount of a CFC's PTI that will have to be taken into account to determine either (i) the dividends which are declared to satisfy the base period dividend requirement, or (ii) the HIA dividend itself. This lack of certainty may prevent taxpayers from maximizing the amount of HIA distributions, and therefore prevent taxpayers from maximizing the amount of offshore earnings reinvested in the United States.

Absent further guidance, a CFC must distribute all of its PTI, determined as of the end of the HIA election year, before it can distribute a HIA dividend. The amount of the CFC's PTI as of the end of the HIA election year, however, will not be known with certainty on the date that it makes an HIA distribution. The tax return for the HIA election year will not be filed until several months after the date of the HIA distribution. The tax return for the prior taxable year also may be filed after the date of the HIA distribution if the distribution is made early in the HIA election year.

In addition, there may be amended returns or audit adjustments for various open years up to and including the HIA election year that affect PTI but which are not finally determined until after the date of the HIA distribution. Despite the Service's laudable initiative to bring large taxpayers current in their audit cycles, many large taxpayers with offshore earnings which potentially could be reinvested in the United States still have several taxable years open to examination. Under the statute as currently drafted, any adjustment by audit or amended return that increases PTI for any taxable year through the HIA election year would retrospectively reduce the HIA dividend, dollar for dollar, by recharacterizing a portion of the HIA distribution as a PTI distribution. Similarly, changes to PTI may affect whether the taxpayer received dividends in excess of the base period amount.

This uncertainty complicates the calculation of the HIA dividend and the tax accrual for that dividend. Corporate tax managers are under increasing pressure to precisely quantify the amount of the income tax accrual for all transactions. For many taxpayers, the decision whether to make an HIA distribution is a very significant one, which can be made only with a full understanding of the financial consequences. The existing uncertainty makes that determination difficult, which discourages maximum reinvestment of offshore earnings in the United States.

Proposed Technical Correction

A technical correction should be enacted to provide taxpayers the same certainty in determining the PTI amount for purposes of calculating the HIA dividend that exists in determining the base period amount and the deferred earnings amount. Both of those amounts are determined as of June 30, 2003. The technical correction should provide that, for purposes of determining the amount of HIA dividends and dividends that are necessary to meet the base period amount, the amount of the distributing CFC's PTI that is taken into account shall not exceed the PTI amount as shown on the most recent return filed for the most recent taxable year ending on or before June 30, 2003 (excluding amended returns filed after that date) ("Fixed PTI Amount"), reduced by actual PTI distributions made prior to the HIA election year.

This proposal would allow taxpayers to calculate their HIA dividend with certainty and to distribute the maximum allowable HIA dividend. Taxpayers would not be required to base their HIA calculations on tentative estimates of a PTI amount that could change by the end of the HIA election year or that could be affected by subsequent audit adjustments.

Under this proposal, taxpayers will be required to distribute the full Fixed PTI Amount prior to distributing an HIA dividend. That distribution could occur in any taxable year after the year in which the Fixed PTI Amount is determined, up to and including the HIA election year. Therefore, if an amount equal to the Fixed PTI Amount had been distributed prior to the HIA election year, distributions would first be made from other E&P, rather than from PTI, up to the applicable base period dividend amount (to the extent not paid by other CFCs) and HIA dividend limits. The CFC's PTI account would remain intact, and distributions in excess of the CFC's share of the base period dividend and the HIA dividend would be attributable to the CFC's PTI account under normal rules.

If it is ultimately determined that, as of the end of the HIA election year, a distributing CFC had PTI in excess of the Fixed PTI Amount, that additional PTI would remain PTI of the CFC. Distributions exceeding the CFC's share of the base period dividend and the HIA dividend made during the HIA election year, or any distribution made in a subsequent year, would be made out of such additional undistributed PTI and other E&P under the normal ordering rules. Accordingly, any uncertainty over the CFC's actual PTI amount would not affect the calculation of the HIA dividend.

The Service may require taxpayers to attach a statement to the return for the HIA election year designating the E&P pools from which these distributions are made.

I have attached a draft of the proposed technical correction as an exhibit.

Policy Reasons for Change

Congress enacted section 965 to encourage cash repatriation to fund investment and job creation in the United States. The proposed technical correction furthers this goal because it increases the certainty with which taxpayers can calculate the HIA dividend, thereby encouraging taxpayers to maximize repatriations to and investment in the United States.

The proposal is consistent with other elements of section 965 which provide certainty in computing the amount of the HIA dividend by allowing taxpayers to rely on tax attributes that are fixed prior to the beginning of the HIA election year.

All other existing limits under section 965 are preserved. The amount of the HIA dividend still could not exceed the distributing CFC's current or accumulated E&P in excess of undistributed PTI, as determined after all audit adjustments for all years through the HIA election year. In addition, this proposal does not affect the amount of deferred earnings that are eligible for the HIA DRD, and it does not alter the base period computation or the reinvestment plan requirement.

In light of the fact that some companies have already made an HIA distribution, it may be appropriate to provide this resolution to affected taxpayers by election.

This uncertainty is created by the unique situation that an HIA distribution can be made for only one taxable year, while the underlying elements that determine the amount of the HIA dividend may cover several years. This proposed technical correction will eliminate this unique uncertainty, and therefore will encourage maximum reinvestment and job creation in the United States. Since it deals with the one-time event of section 965, it will have no future impact on any taxpayer after the completion of the HIA distribution.

Thank you for the opportunity to submit this proposed addition to the Tax Technical Corrections Act of 2005. If you have any questions about this letter, please feel free to contact me at (202) 682–4448.

Marie K. Lee
Tax Counsel

Exhibit

New Section 965(c)(4). To be inserted between current Section 965(c)(3) and Section 965(c)(4).

(4) COORDINATION WITH SECTION 959.—Notwithstanding the rules of section 959, distributions of earnings and profits made by a controlled foreign corporation, which has a United States shareholder that has made an election under this section, shall be applied for the year of election in the following manner:
- (A) First, out of earnings and profits described in section 959(c)(1) and (c)(2), in the order specified in section 959(c), up to the amount of such earnings and profits shown on the most recent return filed for the most recent taxable year ending on or before June 30, 2003 (except that amended returns filed after June 30, 2003, shall not be taken into account), reduced by the amount of distributions that
  - (i) are excluded from gross income under section 959, and
  - (ii) are distributed after the most recent taxable year ending on or before June 30, 2003, and before the taxable year for which the election under this section is in effect;
- (B) Second, out of earnings and profits described in section 959(c)(3), to the extent that dividends received by the United States shareholder from other controlled foreign corporations during such year are less than the amount stated in section 965(b)(2)(B);
- (C) Third, out of earnings and profits described in section 959(c)(3), to the extent of the amount distributed by such controlled foreign corporation which qualifies for the deduction provided in subsection (a)(1); and
- (D) Fourth, out of earnings and profits in the manner described in section 959(c).

New Section 959(g).

(g) COORDINATION WITH SECTION 965.—For special rules relating to the application of this section in years for which an election is made under section 965(f), see section 965(c)(4).

American Forest & Paper Association
Washington, DC 20036
August 31, 2005

The Honorable William Thomas
Chairman, Committee on Ways & Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Chairman Thomas:

The American Forest & Paper Association is pleased to submit the following comments on H.R. 3376, the Tax Technical Corrections Act of 2005.

The American Forest & Paper Association (AF&PA) is the national trade association for the forest products industry. We represent more than 200 companies and related associations that engage in or represent the manufacturers of pulp, paper, paperboard and wood products. America's forest and paper industry ranges from the state-of-the-art paper mills to small, family owned sawmills and some 10 million individual woodlot owners. The U.S. forest products industry is vital to the nation's economy. We employ approximately 1.3 million people and rank among the top ten manufacturing employers in 42 states with an estimated payroll of $50 billion. Sales of the paper and forest products industry top $230 billion annually in the U.S. and export markets. We are the world's largest producer of forest products.

AF&PA very much appreciates the inclusion of technical corrections clarifying the enhanced reforestation amortization (sec. 2(j)(2)(B) of H.R. 3376) and the definition of open-loop biomass under IRC section 45 (sec. 2(t)(2) of H.R. 3376).

Our comments focus on section 2(t)(2) of H.R. 3376, which clarifies the definition of open-loop biomass under IRC section 45:

(2) Clause (ii) of section 45(c)(3)(A) [definition of open-loop biomass] is amended by inserting 'or any nonhazardous lignin waste material' after 'cellulosic waste material.'

The description of H.R. 3376 indicates that this provision "clarifies that open-loop biomass resources include both cellulosic and lignin waste material." Joint Committee on Taxation, Description of the "Tax Technical Corrections Act of 2005," JCX–55–05, page 10.

Subsequent to the introduction of H.R. 3376, this technical correction was enacted as part of the Energy Policy Act of 2005 (sec. 1301(f)(2) of H.R. 6).

AF&PA understands the legislative intent behind the word "nonhazardous" was to ensure that hazardous materials do not qualify for the credit. Lignin is not a hazardous material. In the context of our processes that produces steam and electricity from lignin, however, we are concerned that there could be unintended confusion as explained below. Similarly, we understand that "waste" was included to ensure that the tax incentive did not create competition for woody-biomass material that could be used to make paper or solid wood products. However, as explained below, there could be unintended confusion resulting from a previous IRS ruling that, in another context, found lignin to not be considered "waste." For these reasons AF&PA is seeking further clarification of this language (see also "Written Statement for the Hearing Record," submitted by AF&PA to the Subcommittee on Select Revenue Measures, on June 6, 2005, copy attached).

Wood is composed primarily of cellulose (wood fibers) held together by lignin (the fiber binding agent). The processing of wood for making paper has several stages. The first stage involves the use of pulping chemicals to dissolve wood into cellulose wood fibers and wood residues (mostly lignin). The cellulose wood fibers then are separated and further processed to become paper products. What remains is a combination of pulping chemicals and wood residues or lignin. This combination is referred to as pulping liquors. The next stage involves a process to separate the pulping chemicals from the wood residues or lignin. The pulping chemicals are recovered for reuse in the pulping process. The wood residues (lignin) are burned to generate heat for making steam and electricity.

AF&PA requests two clarifications. First, a clarification that the wood residues are not considered hazardous because they are combined with pulping chemicals prior to their use to generate steam and electricity. Second, a clearer description of lignin to indicate it is a "by product" of the pulping process, rather than "waste" material. This is important because, in a different context, there is an interpretation by the Internal Revenue Service that lignin from the pulping process is not "waste" material (see Technical Advice Memorandum TAM 8722005, February 6, 1987).

AF&PA therefore suggests the following change to the Tax Technical Corrections Act language cited above, with the changes noted in bold:

(2) Clause (ii) of section 45(c)(3)(A) is amended by inserting 'or **any by product of wood or paper mill operations, including lignin in pulping liquors**,' after 'cellulosic waste material.'

This clarification is consistent with the definition of biomass in new IRC section 48B(c)(4)(A) (relating to a new tax credit for qualifying gasification projects).

The description of this provision should be modified to read:

Open-loop biomass (including agricultural livestock waste nutrients) facility

An open-loop biomass facility is a facility using open-loop biomass to produce electricity. Open-loop biomass is defined as (1) any agricultural livestock waste nutrients, or (2) any solid, nonhazardous, cellulosic waste material *or by product of wood or paper mill operations, including lignin in pulping liquors*, which is derived from certain forest-related resources, solid wood waste materials, or agricultural sources and which is segregated from other waste materials. Eligible forest-related resources are mill residues, precommercial thinnings, slash, and brush. Solid wood waste materials include waste pallets, crates, dunnage, manufacturing and construction wood wastes (other than pressure-treated, chemically-treated, or painted wood wastes), and landscape or right-of-way tree trimmings. Agricultural sources include orchard tree crops, vineyard, grain, legumes, sugar, and other crop by-products or residues. However, qualifying open-loop biomass does not include municipal solid waste (garbage), gas derived from biodegradation of solid waste, or paper that is commonly recycled. In addition, open-loop biomass does not include closed-loop biomass or any biomass burned in conjunction with fossil fuel (co-firing) beyond such fossil fuel required for start up and flame stabilization. (Excerpt from Statement of Managers of H.R. 6, page 17.)

AF&PA appreciates the opportunity to present you with these comments. We would welcome the opportunity to discuss this issue with you or to answer any questions you may have.

David G. Koenig
Director, Tax Policy

The American Forest & Paper Association (AF&PA) is the national trade association for the forest products industry. We represent more than 200 companies and related associations that engage in or represent the manufacturers of pulp, paper, paperboard and wood products. America's forest and paper industry ranges from the state-of-the-art paper mills to small, family owned sawmills and some 10 million individual woodlot owners. The U.S. forest products industry is vital to the nation's economy. We employ approximately 1.3 million people and rank among the top ten manufacturing employers in 42 states with an estimated payroll of $50 billion. Sales of the paper and forest products industry top $230 billion annually in the U.S. and export markets. We are the world's largest producer of forest products.

Today, the U.S. forest products industry is facing serious domestic and international challenges. Since 1997, 101 pulp and paper mills have closed in the U.S., resulting in a loss of 70,000 jobs, or 32% of our workforce. An additional 67,000 jobs have been lost in the wood products industry since 1997. New capacity growth is now taking place in other countries, where forestry, labor, and environmental practices may not be as responsible as those in the U.S.

Energy is the third largest operating cost for the forest products industry. In the pulp, paper and paperboard sector of the industry, energy makes up 10–15 percent of the total operating costs. Since 1972, our industry has reduced its average total energy usage by 17 percent through increased efficiencies in the manufacturing and production process. In addition, we have reduced our fossil fuel and purchased energy consumption by 38 percent, and increased our energy self-sufficiency by 46 percent.

The American Jobs Creation Act (H.R. 4520) included a provision to expand the Section 45 tax credit to include open-loop biomass. For purposes of the credit, open-loop biomass is defined as any solid, non-hazardous, cellulosic waste material which is segregated from other waste materials and which is derived from forest-related resources, solid wood waste materials, or agricultural sources. Eligible forest-related resources are mill and harvesting residues, pre-commercial thinnings, slash, and brush. The 2005 credit for electricity produced from open-loop biomass facilities is 0.9 cents per kilowatt hour compared with 1.9 cents per kilowatt hour of electricity generated from closed-loop biomass facilities. To qualify for the credit for both open and closed-loop biomass, the facility must be placed in service prior to January 1, 2006.

The forest products industry is the largest user of biomass for energy production, which is used largely to fuel our wood and paper manufacturing facilities. In addition to biomass like bark, sawdust, and other residues from the wood harvesting and product manufacturing processes, the industry uses biomass in the form of "spent pulping liquors." Spent pulping liquors are created as a residual during the pulping process, and the wood residuals (mostly lignin) are burned in a process that separates and recovers the chemicals for reuse and captures the heat value from the lignin to create steam and electricity. In total, the forest products industry currently uses biomass to generate 60% of its power needs. With continued research and development of new technologies, and expanded tax incentives, the potential exists to greatly increase our industry's capacity for energy production.

Regarding Section 45, the placed in service date for facilities that produce electricity from open-loop biomass needs to be extended from January 1, 2006 to January 1, 2010. Such projects take several years to complete and the industry needs the certainty of knowing that the current tax credit will be available in the future to take the risk of making the investment. At the very minimum, Congress should extend the placed in service date to January 1, 2008 as the Administration proposed in its FY 2006 budget.

Also, clarification is necessary to the Section 45 definition of open-loop biomass to ensure inclusion of the lignin content from spent pulping liquors used to produce electricity at new or expanded facilities. Wood is composed primarily of cellulose (wood fibers) held together by lignin. Wood bark is composed of hemicelluloses. Pulping chemicals are used to dissolve the wood used for making paper. The cellulose fibers become paper products, the pulping chemicals are recycled from recovery boilers for reuse in the pulping process, and the wood residues (mostly lignin) are used to generate heat for making steam and electricity.

Finally, the current inflation adjusted tax credit of 0.9 cents per kilowatt hour needs to be increased to 1.5 cents per kilowatt hour to make the additional electricity produced competitive with other traditional forms of electric generation. The increased tax credit would provide a critical incentive for new investments in energy production facilities connected to current paper mill infrastructure, thus helping to improve the competitive position of the forest products industry.

We appreciate the subcommittee's interest in our thoughts on the need to extend and modify the Open-Loop Biomass component of the Section 45 tax credit.

Washington, DC 20006
August 31, 2005

The Honorable William M. Thomas
Chairman
Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

Dear Chairman Thomas:

The undersigned U.S. flag ocean carriers and associations are writing to propose certain technical corrections to the tonnage tax provisions (Subchapter R) of the American Jobs Creation Act. We would like to express our sincere appreciation for your efforts and those of the Congress to revitalize the U.S. shipping industry and to bring the taxation of U.S. shipping into conformity with global practices regarding the taxation of shipping. We note that H.R. 3376 as introduced contains certain provisions relating to the tonnage tax and we endorse those provisions. We have one additional suggestion that we offer as follows.

The technical correction we propose would define the term "operating agreement" which was introduced in the tonnage tax provisions late in the legislative process. The amendment would define the term consistent with industry practices and provide that operating agreement revenues received by a corporation otherwise eligible for tonnage tax treatment would also be subject to the tonnage tax regime. Whether a corporation meets the "shipping activity" requirement of the Code would, however, be determined without regard to the corporation's operating agreement. We enclose a more detailed explanation of the proposed amendment and legislative language for your consideration.

The amendment meets the standards of a technical correction in that it defines terms not otherwise defined and clarifies the relation of such terms to the structure of the tonnage tax regime. We urge that these provisions be included in the Tax Technical Corrections Act.

American Ocean Enterprises, Inc.
APL, Ltd.
Central Gulf Lines, Inc.
Maersk Lines Limited
Waterman Steamship Corporation
American Maritime Congress
Maritime Institute for Research and Development
The Transportation Institute

Legislative Language of Proposed Amendment

(a) Amendment Related to the American Jobs Creation Act of 2004.—

(1) Amendment related to section 248 of the act.—Paragraph (8) of Subsection (a) of section 1355 of the Internal Revenue Code of 1986 is amended by adding at the end the following: "An 'operating agreement' means an agreement to provide vessel operating services in respect of a qualifying vessel, such as crew, technical, commercial, or other vessel management services or the provision of related equipment, tools, provisions, and supplies by the person providing the operating services. A vessel in respect of which an operating agreement exists shall be treated as bareboat (or sub-bareboat) chartered to the person providing services under the operating agreement and time chartered back to the other party to the agreement. This paragraph shall apply only in the case of a corporation that meets (or is a member of a controlled group that meets) the shipping activity requirement in subsection (c) without regard to this paragraph."

General Explanation of Proposed Amendment

Congress believed operators of U.S. flag vessels in international trade generally were subject to higher taxes than their international competitors, who benefited from tonnage tax and other preferential income tax regimes. Congress believed that this tax differential caused a steady and substantial decline of the U.S. industry and its well-paying, unionized U.S. jobs.

Therefore, Section 248 of the American Jobs Creation Act of 2004 (the "Jobs Act"), added a tonnage tax regime for the taxation of certain U.S. flag vessels. A provision stating that the term "charter" includes an "operating agreement" was added in the conference. No definition of the term "operating agreement" was provided or included in the legislative history, and neither this provision nor the legislative history clarified the consequences of treating an "operating agreement" as a charter to the parties to such an agreement.

The technical correction provides a definition of the term operating agreement that reflects customary practices in the industry, and provides that an operating agreement would be treated as a bareboat charter of the vessel to the operator and a time charter back to the person owning the vessel. This definition applies only to a corporation (or a member of a controlled group) that otherwise meets the statutory shipping activity requirement.

An operating agreement is defined to include an agreement to provide vessel operating services in respect of a qualifying vessel, such as crew, technical, commercial or other vessel management services or the provision of related equipment, tools, provisions, and supplies by the person providing the operating services.

Under the amendment, both the owner and the person providing the operating services qualify for tonnage tax treatment with respect to earnings realized from the operation of the vessel in a qualified trade.

Because the proposed amendment would treat a vessel subject to an operating agreement as bareboat chartered to the person providing the operating services, the operator is permitted to count the vessel that is the subject of the operating agreement for purposes of meeting the "Shipping Activity Requirement" applicable to the operator as is the other party to the operating agreement.

In summary, this technical correction is needed to clarify application of the statute, reflect industry practices, and maintain the competitiveness of U.S. industry.

Technical Explanation of Proposed Amendment

In the Conference on H.R. 4520, the American Jobs Creation Act of 2004 (the "Jobs Act"), Paragraph (8) of Subsection (a) of new section 1355 of the Internal Revenue Code of 1986, as amended (the "Code") was added and provided that the term "charter" includes an "operating agreement." No definition of the term "operating agreement" was provided or included in the legislative history, and neither this provision nor the legislative history clarified the consequences of treating an "operating agreement" as a charter to the parties to such an agreement.

Section 1355 of the Code is part of the alternative tonnage tax regime (Subchapter R) enacted by the Jobs Act, under which a "qualifying vessel operator" may generally elect to be subject to the corporate income tax on certain notional shipping income in lieu of actual amounts of income from "qualifying shipping activities." A "qualifying vessel operator" is defined as any corporation who operates one or more qualifying vessels and who meets the shipping activity requirement of Subsection (c) of section 1355. For purposes of the first prong of the test, a person is generally considered to operate a qualifying vessel during any period that it either owns or charters (including time charters) the vessel (the "Operates Requirement"). Although a person is generally not considered to operate or use a vessel that it charters out on bareboat charter terms, exceptions apply where the vessel is bareboat chartered to another member of such person's controlled group, or where the vessel is bareboat chartered to either a controlled group member or an unrelated person who sub-bareboat charters or time charters the same vessel back to the owner or another member of the controlled group (who ultimately uses the vessel as a qualifying vessel). The second prong of the test, the "Shipping Activity Requirement," is met for any taxable year, if, on average during such year, at least 25 percent of the aggregate tonnage of qualifying vessels used by the corporation (or other members of the corporation's controlled group) were owned by such corporation or chartered to such corporation on bareboat charter terms.

The first sentence of the attached technical corrections amendment provides a definition of an "operating agreement" that would cover agreements typically used in the shipping industry for the provision of vessel operating services in respect of a qualifying vessel.

The second sentence of the proposed amendment clarifies how both parties to an operating agreement can qualify for the tonnage tax provisions in respect of a vessel subject to an operating agreement, assuming that the Shipping Activity Requirement and all of the other requirements of this Subchapter are met. Since the proposed amendment would treat such a vessel as bareboat chartered to the person providing the services under an "operating agreement," such person is treated as satisfying the Operates Requirement. Furthermore, since the proposed amendment treats the vessel in respect of which an operating agreement exists as bareboat (or sub-bareboat) chartered to the person providing the services under the operating agreement *and time chartered* back to the other party to the agreement, such other party is also treated as satisfying the Operates Requirement, regardless of whether the parties to the operating agreement are members of the same controlled group.

The third sentence of this proposed amendment limits applicability of this provision to corporations that meet (or are members of controlled groups that meet) the Shipping Activity Requirement without regard to the treatment of operating agreements as charters under this paragraph. Thus, a corporation will not meet the Shipping Activity Requirement and qualify for the tonnage tax provisions solely by reason of an operating agreement. However, if a corporation (or its controlled group) independently meets the Shipping Activity Requirement (by owning or bareboat chartering sufficient tonnage of other qualifying vessels), it will qualify for the tonnage tax provisions in respect of any qualifying vessel that it is treated as operating by reason of providing services under an operating agreement.

Statement of Mark W. Kibbe, American Petroleum Institute

I. INTRODUCTION

These comments are submitted by the American Petroleum Institute (API) for consideration by the U.S. House Committee on Ways and Means on H.R. 3376, the "Tax Technical Corrections Act of 2005," specifically technical corrections to provisions contained in the "American Jobs Creation Act of 2004" (P.L. 108–357). API represents more than 400 member companies involved in all aspects of the oil and natural gas industry, including exploration, production, transportation, refining, and marketing.

II. PROPOSED TECHNICAL CORRECTIONS

Item 1:

Elimination of Foreign Base Company Shipping Income

Prior Law

For tax years prior to 2005, the subpart F rules required U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation ("CFC") to include currently in income for U.S. tax purposes foreign base company shipping income ("FBCShI") earned by that CFC. FBCShI was income derived from the use of vessels in foreign commerce and generally included the transportation of property between a port in the U.S. and a foreign port, two ports in the same foreign country or two ports in different foreign countries. Prior to its elimination, income qualifying as FBCShI could not be considered any other type of foreign base company income under section 954(a) of the Internal Revenue Code [1] (*see* section 954(b)(6)).

The subpart F rules also require U.S. shareholders of CFCs to currently recognize in income foreign base company oil related income ("FBCORI"). FBCORI includes foreign oil related income as defined by section 907(c) with certain specific exceptions. Section 907(c)(2)(B) defines foreign oil related income as taxable income derived from sources outside the U.S. from, among other items, the transportation of minerals from oil and gas wells or their primary products.

Under section 904(d)(1)(D), taxpayers with shipping income are required to separately calculate a foreign tax limitation on such income. Under section 904(d)(2)(D), shipping income means any income received or accrued by any person which is of a kind which would be FBCShI (as defined by section 954(f)). Income currently recognized as FBCORI is included in the general limitation basket for purposes of section 904.

New Law

The American Jobs Creation Act of 2004 (the "2004 Act") eliminated FBCShI as a category of subpart F income. No conforming amendments were included to address the definition of shipping income for purposes of section 904. However, the 2004 Act does reduce the number of section 904 baskets from nine to two for tax years beginning after December 31, 2006.

Treatment of FBCORI

Eliminating FBCShI allows many taxpayers to defer current recognition of such income for U.S. tax purposes until the U.S. shareholder repatriates it. However, some income earned by CFCs and once qualifying as FBCShI (i.e., shipping income earned from transporting crude from one country to another country) may now also constitute FBCORI, as section 954(b)(6) is no longer operative. Therefore, such income will still be recognized currently for U.S. tax purposes. Further, for section 904 purposes, as the shipping basket in section 904(d)(1)(D) remains in effect through the end of 2006, the FBCORI would not be included in the general limitation basket but would, instead, be recategorized as shipping income. Therefore, for taxpayers incurring certain FBCORI, the current state of the law after the 2004 Act is as if FBCShI were never eliminated.

This is not the same for all taxpayers that have shipping income. Taxpayers with CFCs earning shipping income that is not otherwise subpart F income are able to defer the inclusion of such income until 2007 when the section 904 shipping basket is eliminated. After that date, the repatriation of such income will likely result in inclusion in the general limitation basket for purposes of section 904.

It is not apparent why the policy behind the 2004 Act provision eliminating FBCShI would allow it to essentially remain in effect for taxpayers earning transportation income that also constitutes FBCORI. Even though such income is not deferred due to other subpart F provisions, it should not have to be recategorized as shipping income for purposes of section 904.

Proposed Technical Correction

There is likely a need to retain section 904(d)(1)(D) to the extent taxpayers with CFCs earning shipping income effectively chooses to repatriate such income prior to 2007. However, the shipping basket should be given a lower priority for purposes of section 904 than income recognized as FBCORI. Thus, we recommend the following technical changes to the current statutory language of section 904(d)(2)(D):

Section 904(d)(2)(D)—Proposed technical correction (changes highlighted):

The term "shipping income" means any income received or accrued by any person which is of a kind which would be foreign base company shipping income (as defined in section 954(f) ***as in effect before its repeal***). Such term does not include any

[1] All sections noted herein refer to the Internal Revenue Code of 1986, unless otherwise stated.

financial services income, ***and does not include any foreign base company oil related income (as defined in section 954(g))***.

Section 904(d)(2)(D)—Proposed technical correction (clean version):

The term "shipping income" means any income received or accrued by any person which is of a kind which would be foreign base company shipping income (as defined in section 954(f) as in effect before its repeal). Such term does not include any financial services income, and does not include any foreign base company oil related income (as defined in section 954(g)).

Item 2:

Sale of Partnership Interests

Prior Law

For tax years prior to 2005, the sale of a partnership interest constituted passive income for U.S. foreign tax credit purposes (sections 904(d)(1)(A) and 954(c)(1)(B)(ii)).

New Law

The 2004 Act adopted a "look-thru" rule for certain partnership sales. Specifically, the 2004 Act added section 954(c)(4) which provides that, in the case of any sale by a controlled foreign corporation of an interest in a partnership with respect to which such corporation is a 25-perecent owner, such corporation shall be treated as selling the proportionate share of the assets of the partnership attributable to such interest. In effect, the 2004 Act applies an "aggregate" approach (vs. an "entity" approach) in characterizing gain on the sale of a partnership interest, i.e., it is treated the same as a sale of an interest in a disregarded entity. This is similar to the general approach of other international provisions relating to partnerships. As a result, to the extent that the assets of a partnership are used in a trade or business, the gain on the sale of the interest in the partnership should not be foreign personal holding company income under Subpart F. As a consequence, it should also not be passive income for foreign tax credit purposes.

Ownership Attribution Issue

In order to qualify for the "look-thru" rule for partnership sales, the seller must meet the 25-percent ownership requirement. The Committee Report specifically refers to partners who meet this requirement as ones "owning directly, indirectly, or *constructively* at least 25 percent of a capital or profits interest in the partnership"[2] [emphasis added]. Thus, if a U.S. company owns a 25% (or greater) interest in a partnership through two "sister" CFCs, the "constructive" ownership principle would mean that the ownership interests of the sister companies would be combined in testing the 25% ownership level. Unfortunately, the statutory language did not follow the Committee Report statements, in that no mention of constructive ownership is included in new section 954(c)(4). There is no tax policy reason for this omission, and it appears that it was simply a technical oversight. We recommend a technical correction to conform the statutory language to the stated legislative intent expressed in the Committee Report.

Proposed Technical Correction

The constructive ownership rules of section 958(b) apply for purposes of most of the provisions of Subpart F, and applying these rules for purposes of new section 954(c)(4) would properly allow look-thru treatment where a 25% (or greater) ownership interest in a partnership is split between two (or more) related entities. Thus we recommend the following technical changes to the current statutory language of sections 954(c)(4)(B) and 958(b):

Section 954(c)(4)(B)—Proposed technical correction (changes highlighted):

25-PERCENT OWNER.—For purposes of this paragraph, the term "25-percent owner" means a controlled foreign corporation which owns directly***, indirectly, or constructively (under the rules of section 958)*** 25 percent or more of the capital or profits interest in a partnership.

[2] House Committee Report (Act Sec. 412, H.R. Rep. No. 108–548, pt. 1). The Senate amendment was the same as the House bill, and the conference agreement followed the House bill and the Senate amendment. See Conference Committee Report (Act Sec. 412, H.R. Conf. Rep. No. 108–755). The report language was the same as the language used by the Staff of the Joint Committee on Taxation to describe this same provision in H.R. 4520 (JCX–41–04, p. 90) and H.R. 2896 (JCX–72–03, p. 46).

Section 954(c)(4)(B)—Proposed technical correction (clean version):

25-PERCENT OWNER.—For purposes of this paragraph, the term "25-percent owner" means a controlled foreign corporation which owns directly, indirectly, or constructively (under the rules of section 958) 25 percent or more of the capital or profits interest in a partnership.

Section 958(b)—Proposed conforming amendment (changes highlighted):

CONSTRUCTIVE OWNERSHIP.—For purposes of section 951(b), ***954(c)(4)(B),*** 954(d)(3), 956(c)(2), and 957, section 318(a) (relating to constructive ownership of stock) shall apply to the extent that the effect is to treat any United States person as a United States shareholder within the meaning of section 951(b), ***to treat a controlled foreign corporation as a 25% owner of a partnership under section 954(c)(4)(B),*** to treat a person as a related person within the meaning of section 954(d)(3), to treat the stock of a domestic corporation as owned by a United States shareholder of the controlled foreign corporation for purposes of section 956(c)(2), or to treat a foreign corporation as a controlled foreign corporation under section 957, except that . . .

Section 958(b)—Proposed conforming amendment (clear version):

CONSTRUCTIVE OWNERSHIP.—For purposes of section 951(b), 954(c)(4)(B), 954(d)(3), 956(c)(2), and 957, section 318(a) (relating to constructive ownership of stock) shall apply to the extent that the effect is to treat any United States person as a United States shareholder within the meaning of section 951(b), to treat a controlled foreign corporation as a 25% owner of a partnership under section 954(c)(4)(B), to treat a person as a related person within the meaning of section 954(d)(3), to treat the stock of a domestic corporation as owned by a United States shareholder of the controlled foreign corporation for purposes of section 956(c)(2), or to treat a foreign corporation as a controlled foreign corporation under section 957, except that . . .

Item 3:

Redesignation of Reference to Qualified Activity

In section 952(c)(1)(B)(ii)

Prior Law

Prior to the passage of the 2004 Act, under the flush language in section 952(c)(1)(B)(ii), a qualified deficit that taxpayers could use to offset FBCORI of a CFC included deficits attributable to qualified FBCORI activities arising from 1983 forward. Shipping income, though, could only be offset by shipping deficits arising 1987 forward.

New Law

With the elimination of the shipping income under 954 in the 2004 Act, a conforming amendment was included that eliminated shipping income as a qualified activity under section 952(c)(1)(B)(iii). The remaining activities in that section were also redesignated. However, the flush language in section 952(c)(1)(B)(ii) was never amended to address the redesignation. Accordingly, this section now currently provides that FBCORI deficits prior to 1987 can not be used to offset CFC FBCORI. This was clearly not the intention of the changes adopted by the 2004 Act and, as such, the flush language in 952(c)(1)(B)(ii) should be changed.

Proposed Technical Correction

To address the proper redesignation of which qualified deficits may be used prior to 1986 we propose the following:

Section 952(c)(1)(B)(ii) flush language—Proposed conforming amendment (changes highlighted):

In determining the deficit attributable to qualified activities described in ***clause (iii)(II) or (III),*** deficits in earnings and profits (to the extent not previously taken into account under this section) for taxable years beginning after 1962 and before 1987 also shall be taken into account. In the case of the qualified activity described in ***clause (iii)(I),*** the rule for the preceding sentence shall apply, except that "1982" shall be substituted for "1962."

Section 952(c)(1)(B)(ii) flush language—Proposed conforming amendment (clean version):

In determining the deficit attributable to qualified activities described in clause (iii)(II) or (III), deficits in earnings and profits (to the extent not previously taken into account under this section) for taxable years beginning after 1962 and before

1987 also shall be taken into account. In the case of the qualified activity described in clause (iii)(I), the rule for the preceding sentence shall apply, except that "1982" shall be substituted for "1962."

Item 4:

Treatment of Wholly Owned Partnerships for Purposes of Domestic Manufacturing Deduction

Section 2(a)(7) of the Tax Technical Corrections Act of 2005 ("H.R. 3376") would amend section 199(c) by adding in relevant part:

(D) Partnerships Owned by Expanded Affiliated Groups—For purposes of this paragraph, if all of the interests in the capital and profits of a partnership are owned by the members of a single expanded affiliated group at all times during the taxable year of such partnership, the partnership and all members of such group shall be treated as a single taxpayer during such period.

Because the proposed correction is limited to section 199(c), it is unclear how partnerships that are wholly owned by members of a single expanded affiliated group should be treated for all other purposes of section 199. Therefore, further guidance is needed to ensure that partnerships that are wholly owned by members of a single expanded affiliated group are treated in the same manner as corporations that satisfy the definition of expanded affiliated group under section 199(d)(4)(b).

In addition, the proposed correction requires the partnership to be wholly owned by the members of a single expanded affiliated group at all times during its taxable year. This does not reflect the realities of the business environment where an interest in a wholly owned partnership might be transferred to an entity that is not a member of the same expanded affiliated group without causing a termination of the partnership's taxable year. In such instances, the partnership should be treated as a member of the expanded affiliated group prior to the transfer.

To this end, we propose that for purposes of clarifying section 199, the language cited above in Section 2(a)(7) of H.R. 3376 be deleted from the bill. We further suggest that in addition to the changes proposed in H.R. 3376 to section 199(d)(4), the following language be added:

Sec. 199(d)(4) is amended by adding at the end the following new subparagraph:

(D) Partnerships Owned by Expanded Affiliated Groups—If all of the interests in the capital and profits of a partnership are owned by the members of a single expanded affiliated group, the partnership shall be treated as a member of such expanded affiliated group for purposes of this section.

Association of American Publishers, Inc.
Washington, DC 20001
August 31, 2005

The Honorable William Thomas
Chairman
Committee on Ways & Means
United States House of Representatives
Washington, DC 20515

Dear Messrs. Thomas, Grassley and Baucus:

On behalf of The Association of American Publishers ("AAP"), I want to thank you for including book publishing within the definition of "qualifying production property" in Section 199 of the Internal Revenue Code of 1986, as amended ("Code"). As you know, the AAP is the principal trade association of the U.S. book publishing industry, with over 300 members. Book publishing is very labor intensive so the inclusion of book publishing clearly promotes the purposes of the American Jobs Creation Act of 2004.

On February 14, 2005, the Treasury Department issued Notice 2005–14, I.R.B. 2005–7 ("Notice"), in an effort to resolve certain interpretive issues that have arisen under Code Section 199. The Treasury Department invited comments regarding the Notice and the AAP submitted comments to the Treasury Department on the Notice on March 22, 2005 (copy of our comments are attached for your review).

An issue of specific interest to the publishing industry concerns gross receipts derived from the distribution of books, journals, and similar materials irrespective of the physical or electronic or other medium used to effectuate such distribution to the customer. Our members' publications are increasingly being made available in electronic or other medium in addition to, or in lieu of, traditional printed copies, leaving open the question of whether receipts from the distribution of these materials in electronic or other medium also constitute “domestic production gross receipts” as defined in Code Section 199(c)(4). We have reviewed your letter to the Honorable John W. Snow, Secretary of the Treasury, dated July 21, 2005, where you note near the end “. . . that gross receipts from the provision of services are not treated as domestic production gross receipts, regardless of the fact that computer software may be used to facilitate such service transactions.” We do not believe that the mere provision of a book or journal in electronic or other medium should be considered a service.

The Notice uses Treasury Regulations (“Regs.”) Section 1.48–1(c) as the basis to determine what is included in the definition of “tangible personal property.” The provisions of Regs. Section 1.48–1(c) were drafted to maximize the benefits available to taxpayers eligible to claim the investment tax credit. It is understandable that the provisions of Regs. Section 1.48–1(c) focus more on the distinction between real and personal property than the distinction between tangible and intangible property. The investment tax credit was available only with respect to qualified investment in depreciable tangible personal property. Accordingly, the investment tax credit was generally available with respect to the purchase of machinery used to manufacture or produce inventory. It was generally not available with respect to the inventory itself. As a result, the distinction between real and personal tangible property was of critical importance for many taxpayers; the distinction between tangible and intangible personal property was much less often of critical importance.

By contrast, the provisions of Code Section 199 deal with gross receipts from the sale of tangible personal property. In few cases will the tangible personal property that falls within the provisions of Code Section 199 be depreciable. In the vast majority of instances, it will constitute inventory or property held for sale to customers in the ordinary course of business. As a result, the context in which the distinction between tangible and intangible property is to be made is dramatically different from that existing for purposes of Regs. Section 1.48–1(c). Consequently, the flexibility brought to bear in making the distinction between tangible and intangible personal property for purposes of Code Section 199 should be the same as that brought to bear in making the distinction between real and personal tangible property for purposes of Regs. Section 1.48–1(c).

The provisions of Code Section 263A and the Regs. adopted there under which are also used as a basis in the Notice. The principal focus of the provisions of Code Section 263A is on the production of inventory (or other property held for sale to customers) and is thus similar to the principal focus of Code Section 199 which is on the generation of gross receipts from the sale of inventory (or property held for sale to customers). In each case, it is inventory (or property held for sale to customers) that is at issue. The focus of the analysis as to what distinguishes tangible from intangible property for purposes of Code Section 199 should therefore be similar to that embodied in the Regs. adopted under Code Section 263A.

Regs. Section 1.263A–2(a)(2)(i) confirms that, in general, “section 263A applies to the costs of producing tangible personal property.” Regs. Section 1.263A–2(a)(2)(ii), which is cited with approval in Section 3.04(8)(b) of the Notice, includes in the term “tangible personal property” videocassettes, computer diskettes, books, and similar items. Regs. Section 1.263A–2(a)(2)(ii)(A)(1) deals specifically with books. It provides that Code Section 263A applies to various categories of prepublication costs, including the costs incurred by publishers in writing, editing, compiling, illustrating, designing and developing a book. Regs. Section 1.263A–2(a)(2)(ii)(A)(1) explicitly states that these prepublication costs are required to be capitalized as costs of producing tangible personal property.

If we were permitted to borrow and rephrase the well-known utterance of Gertrude Stein, we would suggest that what Regs. Section 1.263A–2(a)(2)(ii) in essence provides is that “a book is a book is a book” for purposes of Code Section 263A regardless of the medium by which it is transmitted to the customer, and that, as such, it is treated as tangible personal property for purposes of Code Section 263A. We respectfully submit that the same non-technical line of analysis should apply for purposes of determining whether a book or journal constitutes tangible or intangible inventory for purposes of Code Section 199. We believe that a book transmitted electronically to the customer should be classified as a tangible item of inventory for purposes of both Code Section 199 and Code Section 263A.

Clearly, the proper focus of Code Section 199 should be on the treatment of the qualification of a publisher’s prepublication costs rather than the method of delivery selected by the customer. The majority of the production activities and costs involved in the publishing of a book, journal or magazine occur before the activities associated with the determination of the medium of presentation.

Finally, we note that applying a more expansive, non-technical analysis to the definition of the term "tangible personal property" for purposes of Code Section 199 would not be inconsistent with the provisions of Federal copyright law or recent judicial decisions issued interpreting such law. In this regard, 17 U.S.C.A. Section 102(a) provides,

"Copyright protection subsists, in accordance with this title, in original works of authorship fixed in any tangible medium of expression, now known or later developed, from which they can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device."

Thus, copyright protection depends on some degree of embodiment in a tangible medium of expression. The policy behind the Copyright Act was to foster the creation of original works of authorship in an era of rapid changes in the technology of delivery, and it has worked very well. We submit that the same policy considerations are applicable in this instance.

While we hope that the Treasury Department will adopt our comments when regulations are issued, our members wanted to voice their concerns now in the event that some corrections may be needed as a result of the issuance of regulations which may occur within the next month.

Patricia Schroeder
President & CEO

Boies, Schiller and Flexner LLP
Miami, Florida 33131
August 25, 2005

The Honorable Bill Thomas
Chairman of the Committee on Ways and Means
Committee on Ways & Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Chairman Thomas:

We are pleased to submit our written public comment in response to your request for comments related to the "Tax Technical Corrections Act of 2005" (H.R. 3376, S. 1447) (the "*Technical Correction*"). We believe the bill clarifies certain aspects of the Jobs Creation Act of 2004 (the "*Act*"), and offers both practitioners and taxpayers a more reliable framework for the application of the Act. Although the bill is certainly an improvement, we believe that an additional clarification in the Technical Correction would further enhance the reliability of the Act.

PRE-ACT RULES

Of particular concern is the repeal of the "stock exception to the straddle rule." In their day-to-day operations, our clients, and a multitude of other taxpayers, enter into long and short positions, some of which are structured to minimize risk. Section 1092(a)(1)(A) of the Internal Revenue Code, in pertinent part, provides that a loss with respect to a position shall be taken into account only to the extent that the amount of such loss exceeds the unrecognized gain with respect to one or more offsetting positions. This is referred to as the "loss deferral" straddle rule; this rule defers losses on the unwinding of the loss leg of a straddle. The straddle rule has other implications as well, including suspension of the holding period on property for purposes of determining long-term or short-term holding periods. Interest costs incurred on a straddle position must also be capitalized rather than being deducted as a current expense.

For these rules to apply, there, first and foremost, must be a straddle. Section 1092(c)(1) defines a "straddle" as an "offsetting position with respect to personal property." In general, before the adoption of the Act, the term "personal property" did not include stock except under certain limited circumstances. One such circumstance, resulting in a "straddle" under old section 1092(d)(3), was a position in stock, the offsetting position of which was one with respect to substantially similar or related property (other than stock). The aforementioned circumstance, also known as the "stock exception to the straddle rule," was interpreted by many practitioners to mean that a position in stock would not constitute "personal property" as long as such position was offset by another position in respect to the same or similar stock. This meant, for example, that if a taxpayer held a position in stock and an offsetting position in a short equity swap in the same or a similar stock, the stock would not be treated as "personal property." This notion, however, changed with the introduction of proposed regulations section 1.1092(d)–2(c), which narrowed the initial interpretation of the statute to apply only to offsetting positions that were directly in stock or a short sale of stock. Consequently, if a taxpayer established a position in stock and an offsetting position in an equity swap in respect to the same stock, the stock would be treated as "personal property" because the offsetting position was not directly in stock or a short sale of stock.

POST-ACT RULES

The Act modified section 1092(d)(3)(A)(i) to read as follows: **"In the case of stock, the term 'personal property' includes stock only if—(i) such stock is of a type which is actively traded and at least 1 of the positions offsetting such stock is a position with respect to *such* stock or substantially similar or related property" (emphasis added).** The presumed intended effect of this provision was to repeal the "stock exception to the straddle rule." The conference report and the JCT 2004 explanations (the 2004 Blue Book) supports this intention, that "[t]he Act also eliminates the exception from the straddle rules for stock (other than the exception relating to qualified covered call options)." Problematically, footnote 867 of the Conference Report states that, "[it] is intended that Treasury regulations defining substantially similar or related property for this purpose will continue to apply subsequent to repeal of the stock exception and generally will constitute the exclusive definition of a straddle with respect to offsetting positions involving stock. See Prop. Treas. Reg. sec. 1.1092(d)–2(b)."

NEED FOR CLARIFICATION

The language of the new provision in the Act itself suggests that the "stock exception to the straddle rule" is repealed in its entirety. As such, a long position in stock offset by a short position in the same stock, or a short position in a similar stock, should presumably lead to the classification as "personal property" and, hence, to a straddle. However, the underlying history behind the provision may lead to a different interpretation. As we suggest below, footnote 867 may be interpreted to stand for the proposition that the Act repeals only the stock exception in respect to short positions in the *same* stock, but not short positions in stock that is "substantially similar or related property" ("*SSRP*").

The straddle rule was enacted in 1981 for the principal purpose of defeating certain shelter arrangements proliferating at that time by prohibiting the selective realization of losses. To accomplish this, the provision treats two ostensibly separate transactions as if they were one because of the interdependency of the economic relationships and because the taxpayer, but for the loss deduction, would not have changed his underlying economic position.

We believe the failure to clarify the scope of the repeal of the stock exception in the Technical Correction will create unnecessary burden and unintended consequences to taxpayers engaged in non-abusive transactions. For example, a taxpayer holding a long position in GE stock and a short position in a non-grantor trust regulated investment company (a "*RIC*") holding some GE stock will have to determine under the SSRP regulations (Reg. § 1.246–5, Prop. Regs. § 1.1092(d)–2) whether the RIC is SSRP with respect to the GE stock, and based on that determination, whether the positions constitute a straddle under section 1092. Conceivably, for example, at the time the long GE position and the short RIC position were established, the RIC might not have held any GE stock, but might later acquire such GE stock in the ordinary course of business, under which circumstances the taxpayer may then be deemed to have an "unintended" or "unexpected" straddle. A RIC should not be treated the same as a synthetic hedging product. Rather, a RIC is a common non-abusive investment product which, because of its investment objectives and the independence of its investment advisors, makes it an unlikely candidate for tax arbitrage. The additional burden imposed by the Act on taxpayers holding short positions in RICs will outweigh the limited potential for abuse resulting from a taxpayer's limited ability to selectively realize losses under these circumstances.

Footnote 867 also states that proposed regulations section 1.1092(d)–2 will constitute the exclusive definition of a straddle. Apart from the fact that the proposed regulations do not contain a definition of a straddle, the proposed regulations expressly provide that "a position with respect to substantially similar or related property (other than stock) does not include direct ownership of stock or a short sale of stock but includes any other position with respect to substantially similar or related property." If, as the footnote suggests, the proposed regulations continue to be applicable, a short position in a "similar stock"(e.g. a short position in a non-grantor

RIC) or a direct position in a "similar stock" would not be a position in respect to "substantially similar or related property" for purposes of section 1092(d). Accordingly, the offset stock would not be "personal property."

Because the proposed regulations do not provide an exception for short sales in the *same* stock, the new statute in combination with the proposed regulations should be interpreted to *only* repeal the stock exception in respect to short sales in the *same* stock, and to preserve the stock exception for short sales in "*similar or related*" stock. To interpret the legislative history and the statute otherwise would unduly burden taxpayers such as those holding short positions in RICs, with the duty to verify whether each long position they sell at a loss is a part of a straddle with respect to any such short RIC positions. Additionally, any position in a RIC provides limited, if any, potential for abuse through the selective realization of losses.

For the reasons discussed above, we believe footnote 867 should be construed such that the Act repeals only the stock exception in respect to short positions in the same stock, and not short positions in stock that is "substantially similar or related property."

RECOMMENDATION

We believe that Congress intended to resolve the previous ambiguity stemming from the old statute and the proposed regulations, and also intended to repeal the stock exception to the straddle rule with respect to short sales *in the same* stock, but not short sales in similar or related property such as stock similar to the offset stock. Thus, section 1092(d)(3)(A)(i) should be corrected to unambiguously reflect the intent of Congress. We suggest the following language clarification be included in the Technical Correction (clarification in **bold**):

(3) Special Rules For Stock—For purposes of paragraph (1)——
- (A) In General—In the case of stock, the term 'personal property' includes stock only if——
  - (i) such stock is of a type which is actively traded and at least 1 of the positions offsetting such stock is a position with respect to such stock or substantially similar or related property (other than stock), or
  - (ii) such stock is of a corporation formed or availed of to take positions in personal property which offset positions taken by any shareholder.

This language, in conjunction with the proposed regulations, unambiguously states that if the offsetting position is in the same stock, or similar or related property other than a direct ownership of stock or a short sale of stock, the stock will be treated as "personal property."

We are pleased to have been able to offer this comment, and we hope that it will help in clarifying the intent of Congress in respect to the repeal of the stock exception in section 1092. Please do not hesitate to contact us should you have any questions regarding this comment.

Michael Kosnitzky

Cigar Association of America, Inc.
Washington, DC 20006
August 31, 2005

The Honorable Bill Thomas
Chairman
Committee on Ways and Means
United States House of Representatives
Washington, DC 20515

Dear Chairman Thomas:

In response to your request for comments on H.R. 3376, the Cigar Association of America would urge you to make a technical correction to the American Jobs Creation Act of 2004 ("AJCA"), specifically to the provisions under Title VI, the Fair and Equitable Tobacco Reform Act of 2004 ("FETRA"), providing for the buyout of tobacco quota owners and growers. The members of the Cigar Association of America account for more than 96 percent of cigars manufactured, imported, and sold in the United States.

Our comments relate to AJCA section 625, which provides for imposition of assessments as a source for the payments to tobacco quota owners and growers. Section 625(b) requires the Secretary of Agriculture to impose quarterly assessments (during the FY 2005–14 period) on tobacco product manufacturers and importers selling products in the United States, including manufacturers and importers of cigarettes, cigars, snuff, roll-your-own tobacco, chewing tobacco, and pipe tobacco. Section 625(c) provides rules for allocating shares of the total assessment to these different classes of tobacco products.

Cigars erroneously subjected to assessments

From a policy perspective, it was a clear mistake for cigars to be included in the AJCA tobacco buyout assessment regime. The apparent policy justification for the tobacco buyout assessments was that the manufacturing beneficiaries of the Federal tobacco quota/price support program should bear the cost of retiring that program.

That policy does not argue for imposition of the assessments on cigars. The cigar industry simply does not make use of quota tobacco. In 2002, the cigar industry's use of quota tobacco was just 0.025 percent of the total 905 million pounds of quota tobacco grown in the United States. In fact, domestic quota tobacco was used by only one small company in Scranton, Pennsylvania that makes only 0.3 percent of all cigars sold in the United States. By way of comparison, we believe the amount of quota tobacco used by the cigar industry is about the same as the amount used in medical research programs.

Nor does the cigar industry use any significant amount of imported quota-type tobacco. When imported quota-type tobacco is added to domestic quota tobacco, the cigar industry's use of such tobacco remains de minimis—just 0.14 percent of the total used by the entire tobacco industry in 2002. The fact is, cigars sold in the United States are made from a completely different class of tobacco than that at issue in the quota buyout program.

The inclusion of cigars in the AJCA buyout program has much to do, we suspect, with the speed in which the AJCA conference negotiations were concluded. Neither the House-passed nor the Senate-passed buy-out provisions included any buyout assessments with respect to cigars. The House-passed bill included no buyout assessment scheme, while the Senate version's buyout assessment provisions specifically (and correctly) exempted cigars. The assessment regime included in the conference report was wholly new, and developed without the benefit of a full and open airing of views that we believe would have led lawmakers to exempt cigars.

Cigar industry's assessment allocation is miscalculated

A further injustice to the cigar industry is the fact that the industry's allocated share of the total buyout assessment is overstated.

The AJCA initial allocation percentages were determined by reference to 2003 excise tax data. Specifically, the assessment allocations were calculated by multiplying tobacco products (both domestic and imported) "removed" (i.e., subject to tax) in 2003 by the maximum excise tax rate for each class of tobacco. The AJCA methodology resulted in an estimate that cigars accounted for 2.783 percent of total tobacco excise taxes in 2003.

This methodology erroneously assumes that all large cigars were taxed at the maximum rate of $48.75 per 1,000 cigars. In reality, however, a sizable number of cigars are sold at a price that yields a tax per 1,000 that is significantly lower. Furthermore, final Department of Agriculture regulations implementing the assessment regime compound this problem by providing that the same flawed methodology will apply for purposes of determining class allocations for all subsequent years. Accordingly, absent the appropriate exercise by the Department of Agriculture of its regulatory authority to base future assessments on actual tax collections, the allocation percentage for cigars will continue to be misstated going forward.

Actual excise tax data for imported and domestic tobacco shows conclusively that the 2.783 percent share for the cigar industry was grossly overstated. Consider the following:

- U.S. Customs and Border Protection, in an April 21, 2005, letter to the Honorable Jim McCrery (R–LA) (attached), estimated that cigars accounted for 1.5 percent of a total $475.278 million in FY 2003 excise taxes collected on imported tobacco products. Thus, a total of $7.129 million in excise taxes was collected in FY 2003 on cigar imports.
- The Treasury Department Alcohol and Tobacco Tax and Trade Bureau, in a February 11, 2005, letter to Representative McCrery (attached), stated that cigars in FY 2003 accounted for $156.181 million (2.076 percent) of total domestic tobacco excise tax liability of $7,521.707 million. The Treasury letter stated that product class statistics are not maintained with respect to collections.

- Total FY 2003 domestic tobacco excise tax collections were $7,435.498 million, according to Alcohol and Tobacco Tax and Trade Bureau Statistical Release TTB S 5630–FY–2003. If one simply applies the 2.076 percent cigar share of total tobacco excise tax liability to this aggregate collection amount, one can reasonably estimate that total cigar domestic excise tax collections were $154.361 million in FY 2003.

The government data therefore indicates that cigars accounted for $161.490 million ($154.361 million domestic plus $7.129 million imported) of total FY 2003 tobacco excise tax collections of $7,910.776 million ($7,435.498 million domestic plus $475.278 million imported), or 2.04 percent.

Thus, if cigars must be assessed under the buyout program, and the assessment must be based on excise taxes, the industry's allocation should be 2.04 percent—not 2.783 percent as enacted under AJCA.

Unfortunately, the situation only will get worse for the industry over the 2005–14 life of the assessment program. Because the large cigar excise tax is the only ad valorem tobacco excise tax, the cigar industry's share of total industry excise taxes will continue to climb as large cigar prices increase—even if cigar use (relative to other products) remains constant. As the cigar industry's share of taxes rises, its assessment allocation likewise will increase. Based on our projections, the cigar industry's share of total assessments will climb from 2.783 percent to more than 5 percent before the assessments terminate. Looked at another way, the cigar industry's share of assessments will increase from $282 million over 10 years (if the first-year assessment were held constant) to nearly $400 million.

Recommendation

It remains the strong view of the Cigar Association of America that cigars should be removed from the tobacco-buyout assessment regime, for all of the reasons discussed above. Accordingly, we urge you to consider an AJCA technical correction that would accomplish this result.

If a decision is made not to remove cigars from the buyout regime, the alternative technical correction would be to set allocations by reference to the actual share of tobacco excise taxes paid (i.e., 2.04 percent in 2003). Further, in light of the unfair application of the assessment regime to the cigar industry, we would urge that the industry's allocation be frozen at that level for the duration of the assessments.

Norman F. Sharp
President

Clark Consulting
Washington, DC 20001
August 25, 2005

The Honorable William M. Thomas
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Thomas:

I am writing in response to your request for comments on the technical corrections legislation (H.R. 3376) you introduced on July 21, 2005. These comments relate to section 965 of the Internal Revenue Code, enacted as part of the American Jobs Creation Act of 2004, and certain H.R. 3376 technical corrections provisions relating to section 965. As discussed below, clarifications to section 965 may be necessary to allow foreign-owned U.S. companies to repatriate earnings in accordance with the policy intended by Congress in enacting this provision.

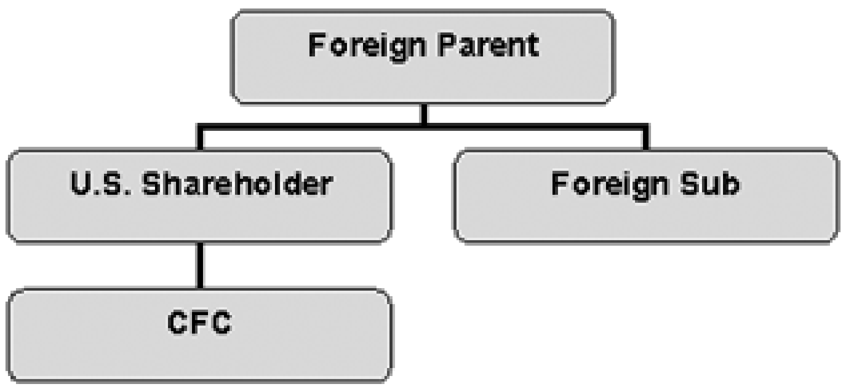
Section 965(b)(3) concerns

By way of background, section 965 generally allows an 85-percent dividends-received deduction for cash dividends received by a U.S. shareholder from a controlled foreign corporation ("CFC") in the U.S. shareholder's 2004 or 2005 taxable year.

Section 965(b)(3) sets forth a limitation based on a CFC's related-party indebtedness. Specifically, the amount of dividends eligible for the deduction is reduced by any increase in CFC indebtedness to related persons between October 3, 2004, and the close of the taxable year for which the deduction is being claimed. Section 965(b)(3)(A) defines a "related person" for this purpose by reference to section 954(d)(3), which defines a related person of a CFC broadly to include any entity that controls the CFC and any entity that is controlled by the same entity that controls the CFC. Section 965(b)(3) treats all CFCs of a U.S. taxpayer as a single corporation for purposes of the borrowing limitation.

The AJCA conference agreement explains that the section 965(b)(3) related-party borrowing limitation is intended to prevent a deduction from being claimed when a U.S. shareholder lends to a CFC in order to finance the payment by the CFC of the dividend. In that case, there would be no net increase in cash in the United States.

The section 965(b)(3) limitation on related-party indebtedness does not appear to have contemplated situations in which a foreign owned U.S. corporation repatriates foreign earnings. While not the prototypical fact pattern, many foreign-owned U.S. companies own a CFC that may be in a position to bring earnings back to the United States. As is the case with CFCs of U.S.-owned multinational corporations, such a CFC may need to access funds in order to pay a dividend. Potential sources could include the foreign parent of the U.S. shareholder and foreign subsidiaries of the foreign parent itself.



As drafted, however, the section 965(b)(3) limitation will deny the CFC the ability to borrow from these non-CFC related foreign persons in order to fund the payment of a dividend that otherwise would qualify for the repatriation provision deduction. This result may have been inadvertent, since payment of a dividend funded by borrowing from a related foreign entity would indeed bring cash to the United States. Funds would move from the foreign entity to the CFC and then to the U.S. shareholder for investment in the United States. This movement of cash is fully consistent with the repatriation provision's intent. These additional potential sources of borrowing (i.e., the ultimate foreign parent and foreign subsidiaries of the foreign parent) available to foreign-owned U.S. companies do not exist for CFCs of U.S.-owned multinational corporations that may have been the prototype for drafters of the provision.

Concerns re: H.R. 3376

H.R. 3376 would expand on the 965(b)(3) related-party debt rule by providing Treasury with explicit regulatory authority to reduce the amount of eligible dividends in certain instances in which dividends are funded by cash transfers from a related party. Specifically, section 2(q)(3) of the bill provides:

The Secretary may prescribe such regulations as may be necessary or appropriate to prevent the avoidance of the purposes of this paragraph, including regulations which provide that cash dividends shall not be taken into account under subsection (a) to the extent such dividends are attributable to the direct or indirect transfer (including through the use of intervening entities or capital contributions) of cash or other property from a related person (as so defined) to a controlled foreign corporation.

The Joint Committee on Taxation ("JCT") summary (JCX–55–05) explains that this regulatory authority "supplements existing principles relating to the treatment of circular flows of cash." The JCT summary further states that this regulatory authority is to be exercised "only in cases in which the transfer is part of an arrangement undertaken with a principal purpose of avoiding the purposes of the related-party debt rule of Code section 965(b)(3)." The summary further discusses certain transfers (e.g., cash contributions for purposes of working capital) that would not be considered as having been undertaken to avoid section 965(b)(3).

The H.R. 3376 cash-transfer rule raises the same policy concerns as are raised by the underlying section 965(b)(3) limitation. That is, the amount of eligible dividends may be reduced when cash is transferred from a related foreign person to a CFC that pays an otherwise-eligible dividend to the U.S. shareholder. This is the result even though such transactions do not involve a circular cash flow (i.e., from the United States to the CFC and back to the United States) and will result in a net increase in cash for domestic investment which is fully consistent with the intent of Congress.

From a practical perspective, the H.R. 3376 cash-transfer rule is creating significant uncertainty in some situations. While the JCT's list of "good" cash transfers is helpful, it is not exhaustive. For example, there may be uncertainty when a CFC sells assets to a related foreign person for cash and pays an otherwise-eligible dividend to the U.S. shareholder.[1] While the taxpayer might argue that such a cash transfer was not made with the principal purpose of avoiding the section 965(b)(3) limitation, both the proposed statutory language and the JCT explanation are sufficiently broad to create uncertainty regarding the ultimate interpretation of this provision. The risk (i.e., the difference between a 35-percent tax rate and a 5.25-percent effective tax rate) would discourage payment of a dividend to the U.S. shareholder in this instance.

Solution

The solution to the concerns discussed above would be to amend section 965(b)(3) to clarify that funding via a loan or cash transfer from a CFC's ultimate foreign parent or a foreign subsidiary of the foreign parent does not disqualify otherwise-qualifying repatriation transactions from the benefits of section 965(a). This could be accomplished by a technical correction excluding foreign related persons from the definition of related persons for purposes of the section 965(b)(3) related-party borrowing limitation:

SEC. ____. AMENDMENT RELATED TO THE AMERICAN JOBS CREATION ACT OF 2004.

(a) AMENDMENT RELATED TO SECTION 422 OF THE ACT—Section 965(b)(3)(A) of the Internal Revenue Code of 1986 is amended by striking '(as defined in section 954(d)(3))' and inserting in its place '(as defined in section 954(d)(3), except that related persons for this purpose shall not include any foreign persons).'

Thus, the section 965(b)(3) limitation would disregard any borrowing by a CFC from its ultimate foreign parent or a foreign subsidiary of the foreign parent. This definition of "related persons" also would apply, by extension, for purposes of the H.R. 3376 cash-transfer rule, which "piggybacks" off of the section 965(b)(3)(A) definition.

To avoid any potential abuse from a circular flow of cash, the legislative history would provide that Congress expects Treasury would treat any back-to-back funding or cash transfer (e.g., a loan from a U.S. related party to a foreign related party coupled with a loan from the foreign related party to the CFC) as a direct cash transfer from a U.S. related party to the CFC for purposes of the related-party indebtedness rule.

A narrower solution, at least for some taxpayers contemplating repatriation transactions, would be to clarify that a cash transfer to a CFC as a result of the sale of assets by the CFC to a foreign related party or a transfer of cash by a foreign related party to repay a bona fide debt owed to a CFC would not be considered as having been undertaken primarily to avoid section 965(b)(3).

In either case, because repatriation transactions generally must be completed by the end of 2005, it would be necessary to communicate this clarification as quickly as possible if technical corrections legislation cannot be enacted in an expeditious manner.

Sincerely,

Kenneth J. Kies

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[1] I am aware of one proposed repatriation transaction viewed now (i.e., after introduction of H.R. 3376) with at least some uncertainty that involves a sale of CFC assets that is required by a foreign regulatory authority and whose planning began prior to enactment of section 965—hardly the type of transaction that should be viewed as abusive in connection with a CFC's payment of a dividend to the United States.

Financial Executives International
Washington, DC 20005
August 25, 2005

The Honorable Bill Thomas
Chairman
Committee on Ways and Means
United States House of Representatives
Washington, DC 20515

Dear Chairman Thomas:

On behalf of the Financial Executives International's (FEI) Committee on Taxation (COT), I am writing to suggest some important revisions to H.R. 3376, the "Tax Technical Corrections Act of 2005." Specifically, we would like to propose some changes to Section 2(a) of the bill, which includes corrections and amendments to Section 199 of the "American Jobs Creation Act of 2004" (Public Law No: 108–357).

FEI is a professional association representing the interest of more than 15,000 CFOs, treasurers, controllers, tax directors, and other senior financial executives from over 8,000 major companies throughout the United States and Canada. FEI represents both providers and users of financial information. The FEI Tax Committee formulates tax policy for FEI in line with the views of the membership. This letter represents the views of the Committee on Taxation.

As drafted, Section 2(a)(7) of the technical corrections bill would amend I.R.C. Section 199(c) by adding in relevant part:

(D) Partnerships Owned by Expanded Affiliated Groups—For purposes of this paragraph, if all of the interests in the capital and profits of a partnership are owned by the members of a single expanded affiliated group at all times during the taxable year of such partnership, the partnership and all members of such group shall be treated as a single taxpayer during such period.

Because the proposed correction is limited to I.R.C. Section 199(c), it is unclear how partnerships that are wholly owned by members of a single expanded affiliated group should be treated for all other purposes of IRC Section 199. Therefore, further guidance is needed to ensure that partnerships that are wholly owned by members of a single expanded affiliated group are treated in the same manner as corporations that satisfy the definition of expanded affiliated group under subsection (d)(4)(b).

In addition, the proposed correction requires the partnership to be wholly owned by the members of a single expanded affiliated group at all times during its taxable year. This does not reflect the realities of the business environment where an interest in a wholly owned partnership might be transferred to an entity that is not a member of the same expanded affiliated group without causing a termination of the partnership's taxable year. In such instances, the partnership should be treated as a member of the expanded affiliated group prior to the transfer.

To this end, we propose that for purposes of clarifying I.R.C. Section 199, the language cited above in Section 2(a)(7) be deleted from the bill and the following be added to Section 2(a)(10):

Sec. 199(d)(4) is amended by adding at the end the following new subparagraph:

(D) Partnerships Owned by Expanded Affiliated Groups—If all of the interests in the capital and profits of a partnership are owned by the members of a single expanded affiliated group, the partnership shall be treated as a member of such expanded affiliated group for purposes of this section.

Thank you for your consideration of our views regarding the tax technical corrections bill. Should you or your staff wish to discuss this matter in further detail, please contact Mark Prysock of FEI's Washington office at (202) 626–7804.

Michael Reilly
Chairman, FEI Committee on Taxation

Florida Institute of CPAs
Tallahassee, Florida 32314
August 29, 2005

The Honorable Bill Thomas
U.S. House of Representatives
Chairman, Committee on Ways and Means
2208 Rayburn
Washington, DC 20515

Dear Chairman Thomas:

On behalf of the Federal Taxation Committee of the Florida Institute of Certified Public Accountants (FICPA), we offer the following comments on the Tax Technical Corrections Act of 2005 (H.R. 3376):

Section 231 of the American Jobs Creation Act of 2004, which deals with members of a family being treated as one shareholder for the number of shareholders limit on S corporations, should be amended so that the treatment is automatic and does not require an election to be made by any family member.

We believe that the requirement for an election to be made by a family member was carried forward from previous versions of this section which would have limited the number of families permitted to be treated as one shareholder for the number of shareholders limitation. Since any number of families can now be subject to this provision, there no longer seems to be a need for an election to be made. The provision for members of a family to be counted as one shareholder should be parallel to the provision that treats a husband and wife as one shareholder without any requirement for one of the spouses to make an election.

Thank you for this opportunity to submit these comments to you.

Ignacio J. Abella
Chair

Washington, DC 20515
August 31, 2005

Dear Chairmen Grassley and Thomas and Ranking Members Baucus and Rangel:

We are pleased to note that H.R. 3376, the "Tax Technical Corrections Act of 2005" does not include a special provision to shield Accenture from the anti-inversion provisions passed as part of last year's international tax law. Please continue to keep such provisions out. Writing new rules with the specific purpose of allowing Accenture to avoid paying millions of dollars in U.S. taxes on its international profits would be extremely unfair to U.S. companies who pay their fair share. We urge you not to incorporate these controversial measures into the bill as it proceeds through the legislative process.

When Congress passed the American Jobs Creation Act last year, it specifically condemned the practice of corporate expatriation. The House report accompanying the legislation states, "The Committee believes that certain inversion transactions are a means of avoiding U.S. tax and should be curtailed." The Committee had it right last year: Accenture's inversion transaction was obviously a means of avoiding U.S. taxes and it should be curtailed—not condoned and rewarded.

This is a question of responsibility. Hard-working Americans, Mom and Pop small businesses, and thousands of corporations with integrity meet their responsibilities by paying their fair share of taxes. Accenture chose a different path: pushing its share of the burden onto others. The Finance Committee and the Ways and Means Committees both have responsibilities of their own: to protect the taxpayers who play by the rules. We appreciate the responsible approach these committees have taken to date by rejecting Accenture's unworthy efforts to flout the laws that bind everyone else.

Please continue to exclude any provisions designed to shield specific companies from existing anti-inversion laws.

Carl Levin
U.S. Senator

Richard Neal
Member of Congress

Lloyd Doggett
Member of Congress

Rosa DeLauro
Member of Congress

Marion Berry
Member of Congress

Louise Slaughter
Member of Congress

John Lewis
Member of Congress

Mcintire School of Commerce
Charlottesville, Virginia 22947
August 27, 2005

The Honorable William Thomas
Chairman, Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Chairman Thomas:

I am writing to request that the Committee on Ways and Means consider technical corrections to Internal Revenue Code Sections 1371(c) and 1367(a)(2)(D) that are, in my opinion, required for the proper and equitable treatment of the incremental taxes incurred by a LIFO-method S corporation under Section 1363(d).

LIFO Recapture under Section 1363(d)

Section 1363(d), which was enacted as part of the Revenue Act of 1987, requires any C corporation that uses the "last-in, first-out" ["LIFO"] method to account for one or more of its inventories and that elects S status,[1] to recognize the "LIFO recapture amount" built into its LIFO inventories as of the end of its last tax year as a C corporation. The "LIFO recapture amount" ["LRA"] is the excess, if any, of the inventory's value determined under the "first-in, first-out" ["FIFO"] method over its actual LIFO value.[2] This amount is included in the converting corporation's ordinary gross income on its final C corporation income tax return, and the resulting incremental income tax is payable in four interest-free annual installments, commencing with the due date for its final C corporation return.[3]

Adjustments to "Earnings and Profits" and to Stockholder Basis for the Incremental Tax Imposed on the Section 1363(d) Inclusion

Background. The statute variously requires that the earnings and profits ["E&P"] of a C corporation, the "accumulated adjustment account" ["AAA"] of an S corporation,[4] and the basis the shareholders of an S corporation have in their stock[5] be reduced by nondeductible, noncapital expenses. Federal income taxes, and more specifically, the corporate-level income taxes imposed on the income recognized under Section 1363(d), are nondeductible, noncapital expenses. Since the converting corporation will be a C corporation at the time the taxes resulting from the recapture of the LRA become "fixed and determinable,"[6] but it (or, following a nontaxable carryover-basis transaction, its successor) will be an S corporation at the time these taxes are actually paid,[7] questions arise as to whether the corporation's E&P, AAA, and/or its shareholders' stock basis are to be adjusted for them, and, if so, when the adjustment is to be made (i.e., immediately on the recapture date or as the installments are actually paid).

The statute expressly provides that in computing an S corporation's AAA, no reduction is to be made for federal taxes "attributable to" any tax year in which the corporation was a C corporation.[8] Although neither the statute nor the regulations define the phrase "attributable to," the incremental tax imposed on the converting corporation's LRA clearly falls within its scope.

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[1] In 1993, the Treasury Department extended the scope of the application of Section 1363(d) to any C corporation that transfers LIFO inventory to a new or pre-existing S corporation in an otherwise nontaxable carryover-basis transaction (e.g., certain corporate reorganizations described in Section 368(a) and certain corporate divisions described in Sections 368(a)(1)(D)/355). Reg. § 1.1363–2(a)(2) (proposed August 19, 1993 and finalized October 6, 1994).

[2] Stated differently, the "LIFO recapture amount" is the cumulative net amount of gross income that the converting corporation (i.e., a C corporation converting to S status) has deferred by using the LIFO method, rather than the FIFO method, to account for its inventory.

[3] The statute also provides for the converting corporation to increase the tax basis of its LIFO inventories to reflect its recognition of this income. LIFO recapture under Section 1363(d) does not terminate the converting corporation's LIFO election.

[4] I.R.C. § 1368(e)(1)(A); Reg. § 1.1368–2(a)(3)(i)(C)(1).

[5] I.R.C. § 1367(a)(2)(D); Reg. § 1.1367–1(c)(2).

[6] As of the last day of the converting corporation's last C year, all events will have occurred which determine the fact of its liability under Section 1363(d) and the amount of that liability will have become determinable with reasonable accuracy. See I.R.C. § 461(h)(4).

[7] This assumes, of course, that the converting corporation's S election (or the S election of its successor corporation) does not terminate prior to the payment of the final installment.

The effect of the incremental tax on the converting corporation's E&P [9] and on the stock basis of its (or its successor's) shareholders is not, however, predicated upon whether or not this tax is "attributable to" a C-corporation tax year of the converting corporation. The touchstone for making these determinations is, instead, whether the incremental tax is deemed to have been "incurred" in the converting corporation's last C year or, alternatively, in a subsequent S year. Simply put, any portion of the incremental tax that is incurred in a C year will reduce the converting corporation's E&P and will have no effect on the stock basis of its (or its successor's) stockholders. Conversely, any portion of the incremental tax that is incurred in the converted corporation's S years will have no effect on its E&P and will reduce its shareholders' stock basis.

The "Economic Performance" Test. An accrual-method corporation's liability for federal, state, and local income taxes is "incurred" (and therefore "recognized") *for any and all federal income tax purposes* [10] only when the "all-events" test of Section 461(h)(4) is met.[11] The all-events test is met no earlier than when the "economic performance" occurs.[12] For liabilities in the form of "taxes," economic performance does not generally occur until the tax in question is actually paid.[13]

An exception to the "payment" requirement is available to accrual method taxpayers that adopt the "recurring item exception" of Section 461(h)(3).[14] Under this exception, taxes will be treated as having been incurred during a particular taxable year *if and only if* (i) the all-events test is satisfied before the close of that taxable year, (ii) payment of the tax is made within the shorter of a "reasonable period" after the close of such taxable year or 8½ months after the close of such taxable year, and (iii) the taxes are recurring in nature and the taxpayer consistently treats taxes of the kind in question as incurred in the taxable year in which the all-events test is satisfied.[15]

With respect to the incremental tax on the Section 1363(d) inclusion, the converting corporation will have been a C corporation at the time the all-events test of Section 461(h)(4) was satisfied, but it (or its successor) will be an S corporation

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[9] The accumulated E&P of a C corporation does not disappear upon its conversion to S status or upon the transfer of its assets to an S corporation in a nontaxable carryover-basis transaction. Instead, the converting corporation's E&P reside in the S corporation (either the converting corporation itself or the transferee of the converting corporation's assets (Sections 381(c)(2) or 312(h))) until they are distributed to its shareholders (as a dividend under Section 1368(c)(2), in redemption of stock, or in complete liquidation), or until they are transferred to another corporation under Section 381(c)(2) or Section 312(h). I.R.C. §§ 1371(c)(2) and (3).

Unfortunately, the converting corporation's E&P has the potential to create significant tax liabilities for the S corporation and/or its shareholders. First, nonliquidating, nonredemption distributions of an S corporation's E&P will be taxable to its shareholders as dividend income. I.R.C. §§ 1368(c)(1) and (2). Second, if the S corporation has any E&P as of the end of any tax year and it has passive investment income in excess of 25% of its gross receipts for the year, it may be liable for a flat 35% corporate-level tax under Section 1375. Finally, if the corporation has E&P and excess passive investment income for three consecutive tax years, its S election will generally terminate as of the beginning of the fourth tax year. I.R.C. § 1362(d)(3).

[10] I.R.C. § 461(h)(1) reads as follows:

"In general. *For purposes of this title*, in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs." [Emphasis supplied.]

[11] "All events test. For purposes of this subsection, the all events test is met with respect to any item if all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy." See also Reg. §§ 1.446–1(c)(1)(ii)(A) and 1.451–1(a).

[12] I.R.C. § 461(h), which generally applies to amounts incurred on or after July 18, 1984. See also Reg. § 1.461–1(a)(2)(i).

[13] Reg. § 1.461–4(g)(6). (An exception to this requirement is available under Section 461(c), which allows an accrual method taxpayer to elect to accrue certain real property taxes ratably over the period to which they relate, regardless of when those taxes are actually paid.)

See also P.L.R. 199904036 (Feb. 1, 1999), where the taxing authority allowed the taxpayer to pay a sales tax liability resulting from an asset acquisition over a period of years. The I.R.S. held that payment, and therefore economic performance, occurred as each payment was made and not when the asset was acquired.

[14] An accrual-method taxpayer may generally adopt the recurring item exception as method of accounting for one or more types of recurring liabilities that it incurs during a taxable year. Reg. § 1.461–5(a). See Reg. § 1.461–5(d) for the time and manner of adopting the recurring item exception.

[15] I.R.C. § 461(h)(3); Reg. § 1.461–5(b). For most liabilities, the recurring item exception also requires that either (i) the amount of the liability in question is not "material," *or* that (ii) the accrual of that liability in the taxable year in which the all-events test is met results in a better "matching" with the income to which it relates than would result from accruing that liability in the taxable year in which economic performance occurs. This requirement is automatically satisfied where the liability at issue is a tax liability. Reg. § 1.461–5(b)(5)(ii).

at the time these taxes are actually paid.[16] A converting corporation that has adopted the recurring item exception, and that pays the incremental tax in installments as they become due, should be permitted to treat the tax paid with the first installment as having been incurred in the recognition year—while it was still a C corporation.[17] The taxes paid with the last three annual installments, however, will be treated as having been incurred in years during which the converted corporation was an S corporation.

Earnings and Profits. The E&P of an accrual method C corporation are reduced by accrued federal income taxes. Section 1371(c), however, provides that no adjustments are to be made to the E&P of an S corporation except (i) where those earnings are distributed out to the shareholders as dividends under Section 1368(c)(2), (ii) where the corporation redeems its stock or liquidates, or (iii) where the corporation acquires, disposes, or allocates E&P as a result of the application of a subchapter C provision to a reorganization or division.[18,19] Section 1371(d)(3) provides another exception that permits an S corporation to reduce its E&P for any additional taxes for which it is liable under the investment credit recapture provisions of Sections 49(b) or 50(a).

Read literally and together, Sections 1371(c) and 461(h) preclude a reduction in the converting corporation's E&P for any amount of the incremental tax not deemed to have been incurred while it was still a C corporation—notwithstanding the fact that such tax is "attributable to" a C year of that corporation. Consequently, a converting corporation that has not adopted the recurring item exception will not reduce its E&P for any amount of the incremental tax paid after the close of the recognition year. A converting corporation that has adopted the recurring item exception and that pays the incremental tax in installments as they become due will reduce its E&P by the amount of the first installment, but no reduction will be permitted for any of the three remaining installments. However, a converting corporation that has adopted the recurring item exception should be permitted to reduce its E&P by any prepayments on the final three installments that are made within a "reasonable period" (or 8½ months, whichever is shorter) following the close of the recognition year.[20]

The failure of the statute or regulations to permit the converting corporation to reduce its E&P by the full amount of the incremental tax in the recognition year is clearly at odds with the whole concept of corporate E&P, i.e., that the before-tax corporate-level earnings and profits of a C corporation should be reduced by the corporate-level taxes attributable to them. In a closely analogous situation, Congress belatedly "clarified" the treatment of federal income taxes paid by an S corporation upon the recapture of investment tax credits previously claimed by the corporation in a prior C year. As noted above, Section 1371(d)(3) permits an S corporation to reduce its E&P by the full amount of such taxes.[21]

The failure of the current statute to permit a converting corporation to reduce its E&P by the full amount of the incremental tax also conflicts with the legislative purpose that triggered the enactment of Section 1363(d): to "eliminate this potential disparity in treatment" between FIFO-method and LIFO-method converting corpora-

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[16] This assumes, of course, that the converting corporation does not prepay the entire incremental tax in the recognition year and that its S election (or the S election of its successor corporation) does not terminate prior to the payment of the final installment.

[17] See, for example, Reg. § 1.461–4(g)(8), Ex. 8.

[18] Consequently, for example, neither the recognition of built-in gains and losses under Section 1374, nor the payment of corporate-level taxes on net recognized built-in gains will have any effect on an S corporation's E&P. Nor will the recognition of "excess net passive income" or the payment of corporate-level taxes thereon under Section 1375 have any affect on an S corporation's E&P.

[19] I.R.C. § 1371(c) was enacted as part of the *Subchapter S Revision Act of 1982*.

[20] Since the converting corporation's liability for the incremental tax on the Section 1363(d) inclusion becomes "fixed and determinable" in the recognition year, and since the statute expressly authorizes the prepayment of this tax, it seems clear that, for a converting corporation that has adopted the recurring item exception, a prepayment of all or part of any or all of the last three installments within a "reasonable period" (or 8½ months, whichever is shorter) following the close of the recognition year, will result in those taxes being "incurred" in the recognition year. I.R.C. § 1363(d)(2)(B) (". . . the 3 succeeding installments shall be paid on *or before* the due date . . . for the corporation's return for the 3 succeeding taxable years." [Emphasis supplied.]

[21] "The Act *clarifies* that an S corporation's accumulated earnings and profits will be reduced by the amount of investment credit recapture tax . . . imposed on the corporation with respect to these credits, *since the earnings and profits were not previously reduced by the amount of tax savings attributable to the credit*." [Emphasis supplied.] Staff of Joint Comm. on Taxation, 98th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (1984): pp. 1019–1025.

tions.[22] As of the date of its conversion to S status, a FIFO-method C corporation would have already reduced its E&P by the income taxes attributable to its inventory profits.

Shareholder Stock Basis. Failure to adjust the converting corporation's E&P by the incremental tax is an inequity that is exacerbated by Section 1367(a)(2)(D), which requires, without qualification, that the shareholders of an accrual-method S corporation reduce their stock bases by their pro rata share of the nondeductible, noncapitalizable expenses incurred during the year.[23] It seems clear that this requirement extends to any amount of the incremental tax that is deemed, under the rules discussed above, to have been incurred during an S year of the converted corporation, notwithstanding the fact that such tax is, in its entirety, attributable to a C year of the converting corporation.[24,25]

Technical Corrections Needed. The literal application of these current provisions creates the potential for substantial distortions in the amount, timing, and character of the income ultimately recognized by the shareholders of the converted corporation. For the reasons stated above, Sections 1371 and 1367 should, in my opinion, be revised to require the accrual of the entire amount of the Section 1363(d) incremental tax on the recapture date—i.e., at the time the liability for that tax becomes "fixed and determinable," without regard to when economic performance ultimately occurs. These revisions would be consistent with the concept of E&P, with the legislative purpose that prompted the enactment of Section 1363(d), with the treatment of corporate-level recapture taxes under Section 1371(d)(3), and with the regulations under Section 1374 (which apply the all-events test *without regard to the economic performance requirement* in distinguishing deductions that were built-in as of the last day of the converting corporations last tax year as a C corporation, and those that accrued subsequent to the start of the Section 1374 recognition period).[26] These changes would also be consistent with the legislative purposes that inspired the changes made to Subchapter S by the *American Jobs Creation Act of 2004*.[27]

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[22] *H.R. Rep. No. 100–391*, Part 2 (1987):

"The committee is concerned that taxpayers using the LIFO method may avoid the built-in gain rules of section 1374. It believes that LIFO method taxpayers, which have enjoyed the deferral benefits of the LIFO method during their status as a C corporation, should not be treated more favorably than their FIFO (first-in, first-out) counterparts. To eliminate this potential disparity in treatment, the committee believes it is appropriate to require a LIFO taxpayer to recapture the benefits of using the LIFO method in the year of conversion to S status." (At p. 1098.)

[23] Reg. §§ 1.1367–1(c)(2) and –1(d)(2).

[24] Although Reg. Sec. 1.1367–1(c)(2) does not include the incremental tax on the Section 1363(d) inclusion in its listing of the types of nondeductible, noncapitalizable expenses that fall into this category, that regulation expressly states that the listing is illustrative, not exclusive. See also Section 1368(e)(1)(A), which directs that AAA is computed by making adjustments that are "similar to the adjustments under Section 1367," *but that* "no adjustment shall be made for Federal taxes attributable to any taxable year in which the corporation was a C corporation." This language seems to confirm that federal income taxes attributable to taxable years in which the corporation was a C corporation are taken into account in making basis adjustments under Section 1367 when they are incurred in an S year.

See also *Preamble*, T.D. 9210 (July 11, 2005), which states that "[t]he issues raised by the payment by an S corporation of taxes attributable to a taxable year in which the corporation was a C corporation are not unique to a payment of the LIFO recapture tax. . . ." (T.D. 9210 extended the application of Section 1363(d) to LIFO inventory held indirectly by a converting corporation through a partnership.)

In my opinion, the Section 1363(d) incremental tax *is* unique and this uniqueness warrants the special treatment described below.

[25] Note that the income taxes payable by a converted corporation under Section 1374 also reduce stock basis. I.R.C. §§ 1366(f)(2) and 1367(a)(2)(B) and (C). However, unlike Section 1363(d), stock basis is also increased by the net recognized built-in gain on which the tax is imposed.

[26] Reg. § 1.1374–4(b)(2), which reads, in part, as follows:

"Deduction items. Except as otherwise provided in this Section, any item of deduction properly taken into account during the 10-year recognition period is recognized built-in loss if the item would have been properly allowed as a deduction against gross income before the beginning of the 10-year recognition period to an accrual method taxpayer. . . . In determining whether an item would have been properly allowed as a deduction against gross income by an accrual method taxpayer for purposes of this paragraph, *Section 461(h)(2)(C) and Section 1.461–4(g)* (relating to liabilities for . . . taxes . . .) *do not apply*." [Emphasis supplied.]

Note also that the corporate-level tax imposed under Section 1374 is treated as a loss sustained by the S corporation for the taxable year in which the built-in income or gain is recognized and the tax is imposed, *regardless of the year in which the tax is actually paid*. I.R.C. § 1366(f)(2) and Reg. § 1.1366–4(b).

[27] P.L. 108–357. The revisions to Subchapter S were designed to "modernize the S corporation rules and eliminate undue restrictions on S corporations in order to expand the application of the S corporation provisions so that more corporations and their shareholders will be able to

Thank you for your time and consideration.

David W. LaRue, Ph.D.

Nalco Company
Naperville, Illinois 60563
August 29, 2005

The Honorable William M. Thomas
Chairman
U.S. House Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

Dear Chairman Thomas and Committee Members:

On behalf of Nalco Company, I submit the attached proposed amendment to H.R. 3376 to clarify the circumstances under which tax credits may be earned under Section 45 of the tax code, as added under provisions of the American Jobs Creation Act of 2004 (the "Act"). The attached clarifying language, provided in draft bill form, relates to Section 710 of the Act.

Among other water treatment and process improvement services, Nalco Company supplies coal preparation and related environmental materials and consulting services. We believe that ambiguous definitions in the Act raise enough uncertainties to limit its potential value. In our view, clarifying language would help ensure that benefits are realized from the Act's intended support for waste coal re-mining and related site reclamation, as well as for technologies to create energy from waste coal with lower sulfur dioxide, nitrogen oxide and/or mercury emissions.

The Internal Revenue Service took more than a decade and hundreds of Private Letter Ruling precedents to implement Section 29. Ambiguities in the Act as it exists for Section 45 today, when combined with the limited size of the credit, could well result in similar delays or complete avoidance of the technology development needed to enable waste coal re-mining and emission reductions from coal preparation technologies.

Additional legislative clarity is needed to provide reasonable assurance that interpretations of legislative intent will remain stable as companies decide whether or not to invest in research and development to support the Act's legislative objective. The attached proposed language represents our best efforts to further clarify several key points. Specifically, the language is intended to clarify that:

- Impoundment waste coal is included in the definition of "feedstock."
- The per-ton credit applies to only the energy-producing coal tonnage left after the waste coal is refined to eliminate non-energy-producing materials.
- Refined waste coal may be blended with newly mined coal in energy production, while applying the credit only to the refined coal.
- Any positive market value for refined waste coal should meet the 50 percent market value improvement criteria, as this waste coal has no value or a negative value in situ.
- An average of 20 percent emission reductions of two of the three pollutant sources discussed in the Act—nitrogen oxide, sulfur dioxide and/or mercury—to enhance the potential producers' ability to meet the Act's intended environmental benefits.

We appreciate the Committee's consideration of our proposal and would be happy to respond to any questions.

Michael R. Bushman

DRAFT BILL

To amend the Internal Revenue Code of 1986 to make technical corrections, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

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enjoy the benefits of subchapter S status." H. Rep. No. 108–548, 108th Cong. 2nd Sess. 128 (2004).

SECTION 1. SHORT TITLE.

This Act may be cited as the "[Renewable Credit and Refined Coal Credit] Tax Technical Corrections Act of 2005."

SEC. 2. TECHNICAL CORRECTIONS.

(a) AMENDMENTS RELATED TO THE AMERICAN JOBS CREATION ACT OF 2004.—

(1) Amendments Related to Section 710 of the Act.—

(A) Clause (i) of section 45(c)(7)(A) of the Internal Revenue Code of 1986 is amended to read as follows:

"(i) is a liquid, gaseous, or solid synthetic fuel produced from coal (including lignite and waste coal) or high carbon fly ash, including such fuel used as a feedstock."

(B) Clause (iv) of section 45(c)(7)(A) of such Code is amended to read as follows:

"(iv) is produced in such a manner as to result in an increase of at least 50 percent in the market value of the refined coal (excluding any increase in heat value caused by materials combined or added during the production process), as compared to the value of the feedstock coal."

(C) Subparagraph (B) of section 45(c)(7) of such Code is amended to read as follows:

"(B) QUALIFIED EMISSION REDUCTION.—

The term 'qualified emission reduction' means a reduction of at least 20 percent of the total emissions of nitrogen oxide and either sulfur dioxide or mercury released when burning the refined coal (excluding any dilution caused by materials combined or added during the production process), as compared to the emissions released when burning the feedstock coal or comparable coal predominantly available in the marketplace as of January 1, 2003."

DESCRIPTION OF THE [RENEWABLE CREDIT AND REFINED COAL CREDIT] TAX TECHNICAL CORRECTIONS ACT OF 2005

TAX TECHNICAL CORRECTIONS

The draft bill includes technical corrections to the recently enacted American Jobs Creation Act of 2004 (the "Act"). The amendments made by the technical corrections contained in the draft bill take effect as if included in the Act.

Clarifications relating to tax credit for production and sale of refined coal (Act sec. 710).—The provision clarifies that waste coal (including coal fines) is a qualifying feedstock which may be converted into qualified refined coal, the production and sale of which generally qualifies for a tax credit of $4.375 per ton of qualified refined coal, subject to adjustment and phase-out. As a consequence, it is against this waste coal feedstock that the 20 percent total emission reduction and 50 percent value increase requirements are applied. If the waste coal has no value, the 50 percent value increase requirement thus will be satisfied to the extent that the synthetic coal has a positive value. This clarification is supported by one of the legislative purposes underlying the enactment of this provision, *i.e.*, encouraging the reclamation and use of waste coals.

The provision also clarifies that the 50 percent value increase requirement should not take into account any value increment resulting from heat value increases due to materials combined or added during the production process. However, the 50 percent value increase requirement should take into account any value increase resulting from the addition of materials in order to obtain a "qualified emission reduction." A significant legislative purpose underlying this provision is the achievement of a "qualified emission reduction." This legislative purpose should not be undercut by excluding value increases attributable to the introduction of materials necessary to achieve a "qualified emission reduction."

The provision clarifies the definition of a "qualified emission reduction." A "qualified emission reduction" is tied to a reduction of the emissions of three substances—nitrogen oxide, sulfur dioxide, and mercury. The provision clarifies that a "qualified emission reduction" is achieved if the process results in a average 20 percent reduction of the total emissions of two of these pollutants, with one of the reduced substances being nitrogen oxide. Achieving 20 percent reduction in the total emissions of two of these pollutants will satisfy the policy of a significant improvement to air quality. Moreover, the 50 percent value increase fundamentally operates to further ensure that the achieved emission reduction is considered valuable by the market, which value inherently is driven by achieving targeted emission reductions and other environmental goals.

Statement of James Tobin, National Association of Home Builders

Thank you for the opportunity to submit comments presenting the views of the National Association of Home Builders (NAHB) on H.R. 3376, the *Tax Technical Corrections Act of 2005*, and the impact the legislation may have on homeowners and the home building industry. NAHB represents more than 220,000 member firms involved in home building, remodeling, multifamily construction, property management, housing finance, building product manufacturing and other aspects of residential and light commercial construction. The success of the home building industry and the benefits of homeownership have been clearly evident in recent years with the housing sector continuing to be an engine of economic growth.

In 2004, in response to World Trade Organization rulings that declared the foreign sales corporation (FSC) regime and the extraterritorial income (ETI) regime prohibited export subsidies, Congress enacted the *American Jobs Creation Act of 2004*. The *American Jobs Creation Act* replaced the FSC/ETI regimes with new tax provisions to aid domestic manufacturers. By reducing the tax burden on domestic manufacturers, the *American Jobs Creation Act* sought to improve the cash flow of domestic manufacturers and increase investment in domestic manufacturing.

The *American Jobs Creation Act* created a new deduction for domestic production activities, which is limited to fifty percent of the wages (i.e. wages reported on Form W–2) paid by the taxpayer. Included in the definition of "qualified production activities income" was domestic production gross receipts generated from construction activities performed in the United States. For this purpose, construction activities are activities directly related to the erection of residential and commercial buildings and infrastructure, including substantial renovation. The new deduction will be a real tax benefit for most home builders and, because the deduction is calculated using wages paid, could represent a substantial deduction for home builders who have a significant number of employees. The deduction will help home builders maintain their role as an engine of economic growth by offsetting some of the escalating costs of developing and constructing a home. For homeowners and potential new home buyers, the deduction will help reduce the cost of owning a new home.

Inevitably, major tax legislation requires technical corrections to ensure the implementation of the new law reflects the intent of the Congressional authors, and the *American Jobs Creation Act of 2004* is no exception. H.R. 3376, the *Tax Technical Corrections Act of 2005*, contains technical corrections with respect to the *American Jobs Creation Act*. NAHB's comments address a specific provision in H.R. 3376 that seeks to clarify that "domestic production gross receipts" exclude gross receipts derived from the lease, rental, license, sale, exchange or other disposition of land (Sec. 2(a)(6)).

The construction of a home, or any structure, begins with the improvement of raw land. Many of NAHB's members purchase land and later sell the land to another builder to complete the final phase of construction. Under the proposal contained in Section 2(a)(6) of H.R. 3376, any income derived from the passive holding of land would be excluded from "domestic production gross receipts" for the purpose of computing the domestic production deduction. This exclusion is unfair and unnecessarily burdensome to home builders.

Excluding land holdings, the raw material on which home construction depends, is unfair to businesses whose livelihood depends upon land acquisition as the basis for their construction activities. Excluding gross receipts derived from the lease, rental, license, sale, exchange or other disposition of land, fails to recognize the true costs, and business, of constructing a home. The passive holding of land is a legitimate business activity and represents a small portion of the income of a home builder. By far, home builders earn the largest part of their income from the construction and sale of homes, an approved activity under the *American Jobs Creation Act*, not from the buying and selling of land. NAHB believes that this reality makes the exclusion unnecessary.

Further, excluding the lease, rental, license, sale, exchange or other disposition of land would require an overly burdensome accounting of gross receipts; complex calculations attempting to divine permitted construction activities from excluded passive land holdings. A large percentage of the 70,000 builder members of NAHB would be required to create land values for each parcel of land in their inventories. For NAHB's members, the majority of which are small businesses and who build only a few homes each year, the information required to identify and separate the gross receipts of a permitted construction activity and an excluded passive land holding is burdensome. For our large-volume members, which potentially have thousands of transactions each year, these calculations are complex and the costs are enormous.

Given the small percentage of gross receipts that home builders derive from passive land holdings and the overly burdensome requirements of computing passive land holdings, NAHB urges you to eliminate the proposed exclusion for the lease, rental, license, sale, exchange or other disposition of land.

Again, thank you for the opportunity to comment on H.R. 3376, the *Tax Technical Corrections Act of 2005*. NAHB looks forward to working with you and the members of the House Committee on Ways and Means as you continue to develop legislation designed to ensure that the new domestic manufacturing deduction reflects your intent.

Statement of the Tony M. Edwards, National Association of Real Estate Investment Trusts

As requested in Press Release No. FC–12 (July 22, 2005), the National Association of Real Estate Investment Trusts® ("NAREIT") respectfully submits these comments in connection with the Committee on Ways and Means' review of H.R. 3376, the "Tax Technical Corrections Act of 2005" (the TTCA). As stated in Press Release No. FC–12, the TTCA includes technical corrections to, among other things, the American Jobs Creation Act of 2004, Pub. L. No. 108–357 (the Jobs Act) including certain provisions relating to real estate investment trusts, which was signed into law on October 22, 2004. NAREIT thanks the Chairman and the Committee for the opportunity to share its views on several important, but technical, issues relating to the Jobs Act's effect on real estate investment trusts.

NAREIT is the representative voice for United States real estate investment trusts (REITs) and publicly traded real estate companies worldwide. Members are REITs and other businesses that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service these businesses.

EXECUTIVE SUMMARY

By way of background, the Jobs Act contains all three titles of the NAREIT-supported REIT Improvement Act (RIA), which was introduced as H.R. 1890. First, Title I of the RIA includes a number of provisions, including one that allows a REIT to make certain loans in the ordinary course of business without the risk of losing REIT status and another that permits timberland dispositions to qualify for a new safe harbor from the 100% prohibited transactions tax. Second, Title II of the RIA substantially conforms the treatment under the FIRPTA rules of foreign shareholders in publicly traded REITs to that of foreign shareholders in other publicly traded U.S. companies. Finally, Title III of the RIA (the REIT Savings provisions) allows companies to avoid REIT disqualification for unintentional REIT test violations either by, among other things, paying a monetary penalty if the violation was due to reasonable cause or, for certain *de minimis* violations, by bringing themselves into compliance with the REIT rules.

Because certain provisions of the Jobs Act could have resulted in retroactive REIT disqualification and/or considerable additional expense, NAREIT submitted written comments to the tax-writing Committees suggesting certain clarifications to the REIT-related provisions in the Jobs Act. NAREIT would like to thank the Ways and Means Committee for favorably addressing these RIA-related changes. However, we have been informed by practitioners that there still may be some potential ambiguity concerning the application of a few of the TTCA provisions concerning effective date issues. Accordingly, as further described below, we have requested further clarification either in statutory language or legislative history. In addition and as further described below, we respectfully request that cross-references be updated in connection with the new safe harbor from the 100% prohibited transactions tax for timberland dispositions. Finally, NAREIT requests the Committee to clarify that REITs are not considered "pass-thru entities" for purposes of § 470 of the Internal Revenue Code, as amended (the Code).[1]

The specific RIA-related items are as follows:

1. A clarification to the transition rule concerning the calculation of "safe harbor securities" under § 856(m)(1) in order to prevent retroactive disqualification of REITs that had held qualifying securities and other securities in compliance with the provisions of pre-Act § 856(c)(7) but did not continue to hold such securities on the date of enactment of the Jobs Act (or shortly thereafter);

[1] Unless otherwise provided, all "section" or "§" references in this submission shall be to a section of the code. § 470 was added by the Jobs Act.

2. Clarification either to the statutory language or the legislative history of the REIT Savings procedures, so that it is clear that it applies to failures of the REIT tests (including those with respect to taxable years prior to date of enactment of the Jobs Act) that are discovered and satisfied after October 22, 2004;
3. A clarification either to the statutory language or the legislative history of the "deficiency dividend" procedure, so that it is clear that statements filed with the IRS in taxable years beginning after October 22, 2004 can relate to distribution errors that occurred in earlier taxable years as well;
4. A clarification of the effective date of the new FIRPTA provisions of the Jobs Act to include "deficiency dividends" of capital gains attributable to pre-Jobs Act years; and,
5. An update of a cross reference in the REIT provisions of the Internal Revenue Code concerning the new safe harbor from the 100% tax for timber sales, to clarify that, based on all the surrounding facts and circumstances, a sale can avoid characterization as a "prohibited transaction" even if all of the requirements of the new safe harbor are not satisfied.

DISCUSSION

A. *Transition Rule for Expansion of "Straight Debt" Safe Harbor*

1. *Background*

In general, a REIT may not own more than 10% of the value of any other entity's securities other than those of a taxable REIT subsidiary (TRS) or another REIT. Prior to enactment of the Jobs Act, an exception to this rule existed for securities that met the definition of "straight debt," and, in the case of "straight debt" securities issued by a partnership, the exception required (at least for REITs that held non-straight debt and equity partnership securities) that the REIT own at least a 20% profits interest in a partnership. Unfortunately, this straight debt exception did not apply to many situations in which individuals and/or businesses owed some debt to a REIT, including non-abusive loans issued in the ordinary course of business.

2. *Jobs Act Change and Technical Issue*

The Jobs Act exempted from the 10% test categories of loans that are non-abusive and presented little or no opportunity for the REIT to participate in the profits of the issuer's business. The Jobs Act also eliminated the requirement that a REIT hold a 20% profits interest in a partnership, but included a limitation that could disqualify from the new "straight debt" safe harbor otherwise qualifying debt securities if the REIT owned non-qualifying securities in the partnership with a value in excess of 1% of the partnership's outstanding securities. § 856(m)(2)(C). The Jobs Act also included a new safe harbor for partnership debt securities that prospectively treats them as qualifying "safe harbor" securities if at least 75% of the partnership's gross income is from the "real estate-related" sources described in Code section 856(c)(3) (such as mortgages and rents).

NAREIT applauds Congress' leadership in enacting these changes and appreciates greatly that they were made on a retroactive basis to 2001, in recognition of the fact that prior to the amendment the "straight debt" rules did not reflect the regulatory regime Congress had originally intended.

Nevertheless, several practitioners have raised the concern that the Jobs Act's retroactive change concerning partnership debt could have resulted in retroactive failures of the asset test for certain REITs that had complied with the provisions of the prior "straight debt" safe harbor, and, accordingly, NAREIT submitted comments to the tax-writing committees expressing this concern. For example, under the Jobs Act, a REIT that owned the following securities in a partnership prior to the enactment of the Act would have been in full compliance with prior law but would fail the 10% value test *retroactively* after the Jobs Act: (a) at least a 20% profits interest in the partnership; (b) "straight debt" securities under § 856(c)(7) (and under § 856(m)(1) prior to the application of § 856(m)(2)(C)) with an aggregate value in excess of 10% of the partnership's outstanding securities; and (c) non-"straight debt" securities with an aggregate value greater than 1%, but less than 10%, of the partnership's outstanding securities that do not qualify for the "real estate partnership" exception.

3. *TTCA Creation of a Transition Rule*

In general, the TTCA evidences the intent to make the Jobs Act's revisions to the prior law "straight debt" safe harbor apply prospectively when the Jobs Act provisions are stricter than prior law. The TTCA 2005 would clarify that securities of a partnership that are held by a REIT on or after October 22, 2004, and that would have qualified and continue to qualify as straight debt of that partnership under prior law rules that required a REIT (that held any partnership equity) to hold at least 20% of the partnership equity, will continue to so qualify while held by that REIT (or successor) until the earlier of the disposition or the original maturity date of the securities.

4. *Potential Issues Raised by TTCA Statutory Language*

a. REIT Disposed of Pre-Jobs Act Qualifying Securities Prior to October 22, 2004

One potentially outstanding issue regarding the TTCA "straight debt" change is that the TTCA requires that the securities have been held by the REIT on October 22, 2004, and continuously thereafter. However, the TTCA did not otherwise change the Jobs Act's retroactive amendment to the prior law "straight debt" exception. As a result, it would appear that it still may be possible for a REIT that held a 20% profits interest in a partnership, along with other qualifying and non-qualifying debt securities, and which met the pre-Jobs Act "straight debt" safe harbor prior to its retroactive change by the Jobs Act on October 22, 2004, *but which disposed of the non-qualifying securities prior to October 22, 2004* to face retroactive disqualification because it would not be holding the 20% profits interest in the partnership on October 22, 2004.

b. REIT Disposed of Pre-Jobs Act Partnership Equity Interest Shortly After October 22, 2004

Another potential issue stems from the fact that the TTCA appears to require a REIT that potentially faced retroactive disqualification under the Jobs Act due to its ownership of a 20% profits interest in a partnership in which it also held "straight debt" securities to continue to own a 20% profits interest following the enactment of the Jobs Act in order for its previously qualifying straight debt securities to continue to be considered "straight debt."

Following enactment of the Jobs Act on October 22, 2004, REITs that faced this retroactive disqualification may have disposed of their partnership profits interest bringing themselves into compliance on a going-forward basis and hoping that any modification to the retroactivity issue raised by NAREIT would be solved only retroactively. Unfortunately, this action appears to eliminate their ability to meet the TTCA 2005's transition rule. Once the REIT no longer holds at least a 20% profits interest, its ownership of other partnership securities may result in the REIT's retroactive disqualification because the REIT would not meet the TTCA's requirement that it continue to comply with the pre-Jobs Act "straight debt" safe harbor.

5. *Recommended Solution*

We suggest essentially the same solution that we proposed in our earlier comments on this issue. Specifically, we suggest that any technical corrections legislation treat the specific securities held by a REIT (or a successor under § 381) on or prior to October 22, 2004, that qualified as "straight debt" as continuing to qualify for the § 856(m)(1) safe harbor (without requiring continued compliance with the pre-Jobs Act safe harbor following October 22, 2004). By enacting such a rule, a REIT that held both straight debt and non-straight debt partnership securities and a 20% partnership profits interest pre-Jobs Act (in compliance with the then-existing safe harbor), but which disposed of any of the securities before October 22, 2004, would not be retroactively disqualified. Similarly, the REIT that held a similar portfolio of debt securities of a partnership's outstanding securities, along with a 20% profits interest (in compliance with the pre-Jobs Act safe harbor), but disposed of some or all of the profits interest between October 22, 2004 and January 1, 2005, also would not be disqualified retroactively. In the latter case, the REIT would have met the pre-Jobs Act safe harbor for taxable years beginning before October 22, 2004, and the post Jobs Act safe harbor for subsequent taxable years.

B. *Clarification That REIT Savings Procedures Apply to Failures of the REIT Tests Both Before and After October 22, 2004 That Are Discovered and Satisfied After October 22, 2004*

1. *Violation of REIT Tests Under Prior Law*

Prior to the Jobs Act change, a REIT could lose REIT status by failing to satisfy a myriad of tests relating to its organizational structure, its sources of gross income, its assets, the distribution of its income, its compliance with various procedures, the transferability of its shares, etc.

2. *Jobs Act Change*

The Jobs Act allows a REIT that fails the asset tests to avoid disqualification by bringing itself into compliance with the asset tests, and in certain cases, paying a penalty. In addition to provisions relating to failures to satisfy the asset tests, the Jobs Act also imposes a monetary penalty of $50,000 in lieu of disqualification for each reasonable cause failure to satisfy the other REIT tests. Intentional violations continue to result in REIT disqualification.

3. *Effective Date of Jobs Act Change*

The effective date of the REIT Savings provisions in the Jobs Act, both for violations of the REIT asset tests and for other REIT test violations, was for "taxable years beginning after the date of enactment." This language could be interpreted to mean that if, for example, in 2006, a REIT found a problem with respect to any of REIT requirements relating to 2004 or earlier, the REIT Savings provisions would not apply. Accordingly, NAREIT requested that the REIT Savings provisions be clarified to apply to failures "discovered" in taxable years after date of enactment of the Jobs Act.

4. *TTCA 2005 Change to the REIT Savings Effective Date*

The TTCA 2005 would amend the effective date for the REIT Savings provisions of the Jobs Act to apply to failures of the REIT tests with respect to which the requirements of the new rules are satisfied after October 22, 2004 (that is, meets the reasonable cause standard if applicable, pays the penalty if applicable, and disposes of assets or otherwise brings itself into compliance). Specifically, in the case of non-*de minimis* failures of the REIT asset tests, the TTCA would modify § 243(g)(4)(A) of the Jobs Act so that it applies to "failures with respect to which the requirements of subparagraph (A) or (B) of section 856(c)(7) . . . are satisfied *after* date of enactment [October 22, 2004]." (emphasis added).

This change appears to mean, for example, that the new REIT Savings provisions apply starting as early as October 23, 2004, when a REIT discovers an asset test violation and then undertakes to cure it, which is what NAREIT had requested. Because asset test violations only can occur on the last date of each calendar quarter, in such a case, the asset test violation must have occurred no later than the last testing date, or September 30, 2004. Nevertheless, some practitioners had expressed concern that the TTCA would not appear to include errors that may have occurred before October 22, 2004, but that were discovered after such date, and requested clarification of this point.

The concern is that because § 856(c)(7)(A)(ii) requires that the asset test failure be "due to reasonable cause and not willful neglect," technically, a pre-date of enactment asset test failure would have been due to reasonable cause pre-date of enactment, and the TTCA requirement that the requirements of § 856(c)(7)(A) be satisfied *after* the date of enactment would not be met. A further source of confusion is that the Joint Committee pamphlet (JCS–55–05) describing this provision in the TTCA states on page 5 that "the new rules that permit the curing of certain REIT failures apply to failures with respect to which the requirements of the new rules are satisfied *in taxable years of the REIT* beginning after date of enactment" (emphasis added). This language is inconsistent with the statutory language, which allows for satisfaction of the new rules presumably immediately after date of enactment, rather than in the next taxable year.

5. *Proposed Solution: Clarification in Legislative History or Statutory Language*

NAREIT urges that the legislative history clarify (or the statutory language be modified) to make clear that the REIT Savings procedures apply to relevant failures of the REIT tests satisfied in taxable years beginning after date of enactment of the Jobs Act (*but the failures that are remedied may have occurred prior to such date*). At the very least, the legislative history should use language similar to that contained in the statute and should include an express statement that the intention is to apply the new relief rules to all failures discovered after October 22, 2004.

C. *Clarification That Statements Concerning "Deficiency Dividends" Can Relate to Distribution Errors That Occurred in Earlier Taxable Years*

Similarly to section B above, the TTCA provision concerning "deficiency dividends" should clarify that the change to § 860 applies to determinations made in taxable years beginning after date of enactment of the Jobs Act and, thus, to errors that may have occurred prior to such date. At the very least, the legislative history should use language similar to that contained in the statute.

D. *Clarification of the Effective Date of the New FIRPTA Provisions of the Jobs Act to Include "Deficiency Dividends" of Capital Gains Attributable to Pre-Jobs Act Years*

1. *Jobs Act Provisions*

Prior to the Jobs Act, the "Foreign Investment in Real Property Tax" (FIRPTA) required a foreign investor who received a REIT capital gain distribution to file a U.S. tax return as though the investor were doing business in the U.S. and, if the investor was taxable as a corporation for U.S. tax purposes, possibly to pay a "branch profits tax." Furthermore, the REIT was required to withhold a 35% tax on such distribution. The Jobs Act modified this rule to treat a capital gain distribution of a publicly traded REIT to a non-U.S. investor as an ordinary dividend so long as the investor owns 5% or less of the distributing REIT "at any time during the taxable year." The change applied to taxable years beginning after October 22, 2004.

2. *Technical Issues Under the Jobs Act*

Because deficiency dividends are treated as deductions in the year in which they relate (that is, the year in which the REIT failed to satisfy the distribution test), it is theoretically possible that a REIT could make a deficiency dividend including capital gain distributions in a taxable year beginning after October 22, 2004, that relates to a taxable year that began prior to October 22, 2004. In such a case, the TTCA's change to the FIRPTA rules would not apply because the deduction would relate to a taxable year prior to date of enactment. Certain practitioners have informed us that this issue is substantial enough that could prevent a "clean" opinion to be issued about the non-FIRPTA status of REIT capital gains distributions paid starting in 2005.

3. *Proposed Solution*

The TTCA clarifies that the FIRPTA change applies to any distribution of a REIT that is treated as a deduction of a REIT for taxable years beginning after date of enactment. NAREIT suggests that this provision be modified so it also applies to capital gain deficiency dividends that are *paid* after October 22, 2004.

E. *Update Cross References in the REIT Provisions of the Code Concerning the New Safe Harbor from the 100% Prohibited Transactions Tax for Timber Sales*

1. *Jobs Act Created Safe Harbor from 100% Tax For Timberland Dispositions*

The Jobs Act establishes a new safe harbor from the 100% prohibited transactions tax on gains attributable to the sale of "dealer property" for sales of timberland. This change is accomplished by adding a new subparagraph to § 857(b)(6). Under previous law, which was not amended, § 857(b)(6)(C) provided for a safe harbor from the prohibited transaction tax from sales of rental property if certain requirements were met (the Rental Safe Harbor). Rules of application relating to the Rental Safe Harbor were contained in § 857(b)(6)(D). Further, § 857(b)(6)(E) specifically provided that the Rental Safe Harbor was merely a safe harbor, and a REIT that failed to meet the safe harbor still could avoid the 100% tax by applying a facts and circumstances test as though the Rental Safe Harbor and the attendant rules of application had not been enacted.

Section 321 of the Jobs Act, entitled "Modification of **Safe Harbor** Rules for Timber REITs," (emphasis added), added a new subparagraph (D) to § 857(b)(6) that establishes a safe harbor for property held for the production of timber (the Timber Safe Harbor). It did so merely by redesignating §§ 857(b)(6)(D) and (E) as §§ 857(b)(6)(E) and (F) and inserting new subparagraph (D).

2. *Omission of Cross References Including Rules of Application of Timber Safe Harbor and Specific Treatment of Timber Safe Harbor as a Safe Harbor*

Although the Jobs Act created the Timber REIT Safe Harbor, it made no other changes to the provisions that referenced subparagraph (C) of § 857(b)(6), the Rental Safe Harbor. As a result, the rules of application contained in former § 857(b)(6)(D) (redesignated § 857(b)(6)(E)) were not extended to the Timber Safe Harbor. Perhaps more importantly, the rules of former § 857(b)(6)(E) (redesignated § 857(b)(6)(F)), allowing a REIT to treat the Rental Safe Harbor as merely a safe harbor, were not extended to the Timber Safe Harbor. As a result, one could make the negative inference that a timber REIT, which under prior law could avoid the 100% prohibited transaction tax if its sold property was not "dealer property" after application of a facts and circumstances analysis, could not do under post-Jobs Act law if it failed to meet the specific Timber Safe Harbor.

3. *Proposal*

Both the rules of application and the provision treating the Rental Safe Harbor as merely a safe harbor should be extended to apply to timberland sales. Specifically, both subparagraphs (E) and (F) to § 857(b)(6) should be amended to make reference to subparagraph (D) after the reference to subparagraph (C). As a result, property sales by timber REITs, like property sales by REITs that own rental property, will be judged based on the rules of application of § 857(b)(6)(E). Furthermore, adding the reference to subparagraph (D) (the Timber Safe Harbor) in § 857(b)(6)(F) will make clear that the Timber Safe Harbor is in fact merely a safe harbor to avoidance of the 100% prohibited transactions tax, rather than the only way for a transaction to not be considered a prohibited transaction.

F. *Clarification that REIT is not "Pass-Thru Entity" Under New Section 470*

1. *Background*

Section 470, added by the Jobs Act, prohibits a taxpayer from claiming a deduction in excess of the taxpayer's gross income with respect to the lease of "tax-exempt use property."[2] The term "tax-exempt use property" is defined by reference to section 168(h), which includes: (i) tangible property leased to tax-exempt entities;[3] and, (ii) *any* property owned by a pass-thru entity with a tax-exempt entity as an owner if the pass-thru entity's allocation of items to the tax-exempt does not constitute a qualified allocation.[4] Thus, under section 168(h) and, in turn, section 470, tax-exempt use property includes not only real property leased to tax-exempt entities but also all other real property, regardless of its use, owned by a pass-thru entity with a tax-exempt or foreign owner.[5]

2. *Issue*

Our concern arises from the fact that neither sections 470 and 168(h) nor the accompanying legislative history defines a pass-thru entity for this purpose. Adding to the uncertainty is the fact that, notwithstanding the general tax treatment of a REIT as a corporation, there are a few instances in the Code in which a pass-thru entity is defined to include a REIT.[6]

The statutory language and legislative history clearly indicate that REITs were not the target of this provision. Instead, section 470 was designed to prevent taxpayers from claiming tax benefits generated in "Sale-In Lease-Out" ("SILO") transactions,[7] which the IRS recently declared to be abusive tax avoidance arrangements.[8] First, a REIT by definition is required to be taxable as a domestic corporation.[9] Further, section 1361(a)(2) states that "[f]or purposes of this title" the term "C corporation" is defined as a corporation that is not an S corporation. Thus, REITs are C corporations for all purposes of the Code unless a Code section otherwise expressly provides. As you know, widely held C corporations rarely are considered pass-thru entities for federal income tax purposes because they cannot pass through losses to their shareholders.[10] In fact, we are not aware of any IRS guidance holding that a REIT is a pass-thru entity in the absence of express statutory direction. Unlike other Code sections, neither section 168 nor section 470 provides that REITs are pass-thru entities rather than C corporations.

Second, even prior to the enactment of section 470, REITs generally had no incentive to engage in a SILO-type transaction because, unlike traditional pass-thru entities (*i.e.*, a partnership), REIT-level losses or credits do not flow through to its shareholders. Further, a REIT generally has little or no taxable income because it may deduct dividends paid to shareholders, and it must distribute most of its taxable income as dividends.[11] Given the tax treatment of REITs, there was no benefit to its shareholders for a REIT to create deductible losses through a SILO arrangement. In fact, one of the most attractive features of investing in a REIT is earning

[2] Section 470(a).
[3] *Id.* § 168(h)(1).
[4] *Id.* §§ 168(h)(6)(A), (E).
[5] *Id.* § 168(h)(6)(A).
[6] *Id.* §§ 1(h)(10)(B); 860E(e)(6)(B); 1260(c)(2).
[7] H.R. Rep. No. 108–548, pt. 1, at 313–14 (2004) (noting that the prior law was ineffective in curtailing the ability of a tax-exempt entity to transfer tax benefits to a taxable entity through certain leasing arrangements); S. Rep. No. 108–192, at 198 (2003) (same).
[8] Notice 2005–13, 2005–9 I.R.B. 1 (designating SILOs as a listed transaction).
[9] Section 857(a)(3).
[10] *See*, *e.g.*, section 469(a)(2), which applies the passive loss rules only to individuals, estates, trusts, personal service corporations, and **closely held** C corporations.
[11] *Id.* § 561.

positive income through the high dividend yield that results from the requirement that a REIT must distribute at least 90 percent of its taxable income annually.[12] In most cases, investing in a SILO arrangement actually would have an adverse effect on a REIT because the losses associated with a SILO would decrease REIT taxable income, which, in turn, would decrease the all-important dividend yield of the REIT's stock. Further, presumably the promoters of SILOs price into the transaction tax benefits that investors receive from artificial losses or credits. Thus, SILO transactions should generate less cash to REITs and their investors compared to the economic leasing transactions that are the basis on which REIT investors evaluate REIT management.

A REIT is principally evaluated by the public markets based on the consistency of its income generating capacity and its ability to grow the income stream over time. Thus, a REIT property usually does not generate deductions in excess of income, other than when it is newly constructed or renovated and has not yet "stabilized" its tenant base. Yet, even though section 470 would rarely operate to suspend losses for a REIT property, an SEC-registered REIT would be compelled to undertake substantial verification procedures to document each property's profitability. Public REITs already are expending millions to comply with section 404 of the Sarbanes-Oxley Act, and to layer on top of this extensive review procedure additional inquiries for the rare instance when a property generates a net loss that cannot even be allocated to a REIT shareholder is excessive, unnecessary, and unproductive both for the REIT and the IRS. This waste of resources is particularly acute with respect to transactions entered into in 2004, for which REITs are currently preparing SEC filings.

3. *Proposal*

For these reasons, NAREIT respectfully requests that the TTCA clarify that, for purposes of sections 470 and 168, a REIT is not pass-thru entity within the context of section 168(h)(6)(E).

NAREIT thanks the Committee for the opportunity to comment on this important legislation.

National Council of Farmer Cooperatives
Washington, DC 20001
August 31, 2005

United States House of Representatives
Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20510

Dear Chairman Thomas:

The National Council of Farmer Cooperatives (NCFC) respectfully submits the following comments on H.R. 3376, the Tax Technical Corrections Act of 2005 (the Act). NCFC would like to commend you for your leadership on the passage of the "American Jobs Creation Act" (AJCA). We believe the new Internal Revenue Code Section 199 deduction for qualified production activities income, created by the AJCA, will spur economic growth and will help farmer cooperatives and their members realize greater income potential.

Farmer cooperatives provide over 300,000 jobs in the United States, with a total payroll in excess of $8 billion, and contribute significantly to the economic well-being of rural America. Since 1929, NCFC has been the voice of America's farmer cooperatives. Our members are regional and national farmer cooperatives, which are in turn comprised of more than 3,000 local farmer cooperatives across the country.

Our comments address several issues relating to the implementation of the Section 199 deduction.

Clarify Language Regarding Denial of Deduction for Portion of Qualified Payments

The Act proposes the language of Code Section 199(d)(3)(B) as follows:

"(B) COOPERATIVE DENIED DEDUCTION FOR PORTION OF QUALIFIED PAYMENTS.—The taxable income of a specified agricultural or horticultural cooperative shall not be reduced under section 1382 by reason of that portion of any quali-

[12] *Id.* § 857(a)(1).

fied payment as does not exceed the deduction allowable under subparagraph (A) with respect to such payment."

Our understanding of the meaning and purpose of the language is illustrated by the following example:

Assume a "specified agricultural or horticultural cooperative" has net earnings of $1 million for its fiscal year ended September 30, 2006, from marketing the agricultural or horticultural products of its members. All of the net earnings are qualified production activities income by reason of Section 199(d)(3)(D). The cooperative markets its members' products on a buy/sell rather than a pooling basis.

On December 15, 2006, the cooperative pays a patronage dividend of $1 million to its members and notifies its members that it is passing through $30,000 of Section 199 deductions. Patron A, whose products account for 1 percent of the products marketed by the cooperative for the year, receives a $10,000 patronage dividend and is notified that $300 of Section 199 deductions has been passed through to him or her.

In this example, it is our understanding that the "qualified payment" (i.e., the portion of the patronage dividend "attributable to qualified production activities income with respect to which a deduction is allowed to such cooperative under subsection (a)") is $30,000. In this case, since the cooperative passed through the full amount of its Section 199(a) deduction for the year, the "portion of any qualified payment as does not exceed the deduction allowable under subparagraph (A) with respect to such payment" is also $30,000. This language refers to the deduction allowable to members of the cooperative and the members as a group are entitled to deduct $30,000 under Section 199(a).

Under Section 199(d)(3)(B), the cooperative is entitled to claim a patronage dividend deduction of $970,000 (i.e., its patronage dividend reduced by the amount of Section 199 deduction passed through) and to claim a Section 199 deduction of $30,000 on its 9/30/2006 return. The members (assuming that they are all calendar year taxpayers) are required to include $1,000,000 of patronage dividends in income and are entitled to deduct $30,000 under Section 199(a) on their 2006 income tax returns.

Absent any special language in Section 199, the cooperative in the example would have been entitled to both a Section 1382 patronage dividend deduction of $1 million and a Section 199(a) deduction of $30,000. The language of Section 199(d)(3)(B) is obviously intended to prevent both the cooperative and its members from claiming the benefit of the portion of the Section 199(a) deduction passed through.

However, the approach taken in the Technical Correction, namely reducing the cooperative's patronage dividend deduction, while allowing both the cooperative and its members to claim a Section 199 deduction in the amount of $30,000, is counterintuitive. We are concerned that the IRS might some day argue that *both* the cooperative's patronage dividend deduction and its Section 199(a) deduction should be reduced by the amount passed through, a clearly incorrect result. There is no clear statement in the Technical Correction that the cooperative remains entitled to the full Section 199(a) deduction.

We assume that the language was drafted as it was in order to leave the cooperative (and not the members) accountable if it is later determined on audit that the proper amount of the Section 199 deduction for the year was less than $30,000. We do not disagree with that approach to treating audit adjustments.

At a minimum, we suggest that an explanation (and perhaps an example) should be set forth in any committee report that accompanies the Tax Technical Corrections Act of 2005 so that the language of Section 199(d)(3)(B) will not later be misconstrued.

We also question why the phrase "as does not exceed" is used in this section instead of simply stating that the patronage dividend will be reduced by an amount "equal" to the Section 199(a) deduction passed through. Are there instances where the adjustment to the patronage dividend can be less than the amount of the Section 199(a) deduction passed through? The language seems to suggest that might be the case.

Clarify Timing of the Deduction

The statutory language as proposed in the Act (Code Section 199(d)(3)(A)) provides that any person who receives a Section 199 "qualified payment" from an agricultural or horticultural cooperative will be allowed a deduction "for the taxable year in which such payment is received" so long as the amount is "identified by such cooperative in a written notice mailed to such person during the payment period described in section 1382(d)."

It is likely that many cooperatives, particularly those that pay patronage dividends relatively soon after year end, will not yet know the precise amount of their

Section 199 deduction for a year when patronage dividends are paid. To determine the amount of the Section 199 deduction, a cooperative's tax return will need to be substantially complete. However, Section 6072(d) provides cooperatives with a due date (without extensions) for their tax returns that is eight and one-half months after year end.

Consequently, the effect of the provision as written is to require taxpayers to take the deduction at the time they receive their patronage payment (part of which is the "qualified payment"), even though they may be notified of the pass-through of the Section 199(a) deduction after they file their returns. This result would require taxpayers to file amended returns. A more efficient solution would be to allow taxpayers to take the deduction in the tax year in which they receive notice from the cooperative.

To illustrate our concern with the timing of the deduction, we offer the following example:

Assume the facts are the same as the prior example except that the cooperative also engages in other nonmember/nonpatronage activities which result in net nonmember/nonpatronage income for the year of $500,000. At the time the cooperative pays its $1 million patronage dividend deduction (December 15, 2006), the cooperative has not yet completed its tax return and is uncertain as to the precise amount of its qualified production activities income and its Section 199(a) deduction. When the cooperative pays its patronage dividend, it passes through $25,000 of Section 199(a) deductions, determined based upon a conservative estimate. When the cooperative completes its 9/30/2006 tax return for filing in June 2007, the cooperative determines that it is entitled to a $30,000 Section 199 deduction for the year with respect to the business it conducts with its members. The cooperative sends notices to its members before June 15, 2007, notifying them that an additional $5,000 of Section 199(a) deductions passes through to them.

Must members amend their 2006 income tax returns if they want to claim the benefit of the additional Section 199(a) deductions passed through to them on June 15, 2007? That is what the statute seems to require. Given that many agricultural and horticultural cooperatives have thousands of members, that does not seem to us to be a practical result.

Clarify Deduction Applies to Goods Manufactured, Produced, Grown, or Extracted *within the United States*

Code Section 199(c)(4)(A)(i)(I) provides that income attributable to domestic production activities is income derived from "qualifying production property which was manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part *within the United States* . . ." (emphasis added).

However, the language of Section 199(d)(3) leaves out these critical words in several places. The first is in the definition confirming that supply cooperatives can qualify as "specified agricultural and horticultural cooperatives." Section 199(d)(3)(F)(i) provides that it applies to cooperatives engaging "(i) in the manufacturing, production, growth, or extraction in whole or in significant part of any agricultural or horticultural products." In addition, Section 199(d)(3)(D) states that cooperatives "shall be treated as having manufactured, produced, grown, or extracted in whole or significant part any qualifying production property marketed by the organization which its patrons have so manufactured, produced, grown, or extracted."

We recommend that the phrase "within the United States" be added to Sections 199(d)(3)(D) and 199(d)(e)(F)(i).

Eliminate Ambiguity Regarding Supply Cooperatives

The statutory language as proposed in the Act (Code Section 199(d)(3)(F)(i)) provides that the pass-through provisions apply to Subchapter T cooperatives engaged "in the manufacturing, production, growth, or extraction in whole or significant part of any agricultural or horticultural product . . ."

This language is intended to include supply cooperatives, as was made clear in Footnote 33 of the Managers' Report to the AJCA (H. Rept. 108–755):

"33. For this purpose, agricultural or horticultural products also include fertilizer, diesel fuel and other supplies used in agricultural or horticultural production that are manufactured, produced, grown, or extracted by the cooperative."

See also Notice 2005–14, 2005–7 I.R.B. 498 (February 14, 2005), Section 4.07 (last sentence), which repeats this language.

Clearly, Congress intended that supply cooperatives be eligible for the pass-through provision. We recommend that the statute be clarified as follows (clarifying language is italicized):

"(F) SPECIFIED AGRICULTURAL OR HORTICULTURAL COOPERATIVE.—For purposes of this paragraph, the term 'specified agricultural or horticultural cooperative' means an organization to which part I of subchapter T applies which is engaged——

"(i) in the manufacturing, production, growth, or extraction in whole or significant part *in the United States* of any agricultural or horticultural products (*including any supplies used in agricultural or horticultural production*), or

"(ii) in the marketing of agricultural or horticultural products."

Clarify Treatment of Wage Limitation

The statute should clarify that the Section 199 deduction of a cooperative is subject to the W–2 wages limitation at the cooperative level only and that it is not subject to a second W–2 wages limitation at the patron level if it is passed through to the patron.

We recommend that the statute be clarified by adding the following sentence at the end of Section 199(d)(3)(A): "The limitation of Section 199(b) does not apply to the amount received from an organization to which part I of subchapter T applies."

We appreciate the opportunity to make comments with respect to the application of Section 199 to farmer cooperatives and their members. We would be happy to answer any questions you may have regarding our comments; please direct your questions to Marlis Carson, General Counsel, at 202–879–0825.

Jean-Mari Peltier
President and CEO

Statement of Professor Gail Levin Richmond, Nova Southeastern University Law Center, Fort Lauderdale-Davie, Florida

This statement is submitted with regard to Act section 2(ee), which would amend section 121(d)(10), as added by section 840 of the American Jobs Creation Act of 2004. In my comments, which relate to Act section 2(ee)(2), I refer to the Code section involved as section 121(d)(11) (a correction I assume will pass as introduced).

The proposed change to section 121(d)(11) is an improvement over the version enacted in the American Jobs Creation Act of 2004. But, as I discuss below, it may not fully solve problems caused by the current statutory language.

The American Jobs Creation Act of 2004 added a new requirement to section 121. Property acquired in a section 1031 like-kind exchange is ineligible for the section 121 exclusion if it is sold within five years of the exchange. That provision had a worthy purpose. Given the increase in land prices, a taxpayer could avoid significant gain recognition with respect to unimproved land held for investment by exchanging it for improved real estate on which a house was situated.

The taxpayer could rent the house (or merely hold it for future appreciation) for the minimum period needed to convince the tryer of fact that a section 1031 like-kind exchange actually occurred. (Because both the property transferred and the property received must be held for business or investment use, a taxpayer could not qualify for like-kind exchange treatment by exchanging investment land for a principal residence.) After the obligatory waiting period, which might be as short as a year, the taxpayer could move into the house, live in it for two years as a principal residence, and sell it.

By following that path, a married couple could shelter up to $500,000 of gain, much of which could be attributable to investment land (whose basis carried over to the home) that was never used as a residence, much less a principal residence. Because section 121(c) relief was available if unforeseen circumstances triggered an earlier sale, taxpayers might still exclude a significant portion of their gain even if the sale occurred before two years of residence.

In attacking that potential abuse, current section 121(d)(11) failed to use precise language. It applied the five-year wait period if "a" taxpayer acquired the property in a section 1031 transaction. The current language is:

If a taxpayer acquired property in an exchange to which section 1031 applied, subsection (a) shall not apply to the sale or exchange of such property if it occurs during the 5-year period beginning with the date of the acquisition of such property.

As worded, the five-year taint applies to anyone, even a good faith purchaser for value, if "a" taxpayer acquired the property in a section 1031 exchange. A taxpayer who purchased the property from the person who entered into the exchange would have a five-year wait for section 121 eligibility even if he or she had never been involved in the type of transaction the section was enacted to discourage.

H.R. 3376 would change the language to eliminate the indefinite reference to. It substitutes the following language:

If a taxpayer acquires property in an exchange with respect to which gain is not recognized (in whole or in part) to the taxpayer under subsection (a) or (b) of section 1031, subsection (a) shall not apply to the sale or exchange of such property by such taxpayer (or by any person whose basis in such property is determined, in whole or in part, by reference to the basis in the hands of such taxpayer) during the 5-year period beginning with the date of such acquisition.

The proposed language removes the potential taint applied to a good faith purchaser. It does not, however, solve every potential problem. Before the Committee finalizes the language of section 121(d)(11), I hope it will consider whether two groups of individuals should be exempted from the five-year taint:

1. Taxpayers who inherit the property. If section 1014 remains the law, they will be exempt from section 121(d)(11) because they do not take the basis used by the taxpayer who entered into the exchange. But, if section 1014 is repealed and replaced by section 1022 carryover basis (currently scheduled for 2010), the recipient will be unable to use section 121 until the full five-year taint expires. This could work a significant hardship in the situation of an unexpected death.

2. Taxpayers who receive the home in a divorce and must sell for unforeseen circumstances related to health or finances. If the marriage occurred after the exchange, it is possible the recipient spouse received no benefit from the original section 1031 tax deferral. But, because of the section 1041 carryover basis rules, that spouse will be burdened by the full built-in gain and will be subject to the taint period. Even if both spouses benefited from the exchange, only the recipient spouse bears the five-year taint. Perhaps this result could be improved if section 121(d)(11) allowed a recipient spouse to qualify for section 121(c) relief based on unforeseen circumstances. Section 121(d)(11) currently appears to preclude such relief. As written, section 121(d)(11) is a trap for unwary domestic relations lawyers.

I have previously discussed problems with the current version of this Code section. See, e.g., Gail Levin Richmond, Section 121(d)(10): An Article Addressing An Article, Tax Notes, February 14, 2005, at 797; Mona L. Hymel, Roberta Mann & Gail Richmond, The American Jobs Creation Act's Impact on Individual Investors: A Monster of Complexity?, 22 Journal of Taxation of Investments 187, 198–204 (2005). I do not represent any client or other party in making these comments or in my other writings on this topic.

Organization for International Investment
Washington, DC 20036
August 31, 2005

The Honorable Bill Thomas
Chairman of the Ways and Means Committee
2208 Rayburn House Office Building
United States House of Representatives
Washington, DC 20515

The Honorable Charles Grassley
Chairman of the Finance Committee
135 Hart Senate Office Building
United States Senate
Washington, DC 20510

The Honorable Max Baucus
Ranking Minority Member of the Finance Committee
511 Hart Senate Office Building
United States Senate
Washington, DC 20510

Dear Chairmen Thomas and Grassley and Senator Baucus:

The Organization for International Investment ("OFII") appreciates your introduction of the Tax Technical Correction Act of 2005 in July. The enactment of this legislation will resolve a number of ambiguities in the American Jobs Creation Act of 2004 ("AJCA"), permitting taxpayers to move ahead with their tax compliance and planning. OFII offers the following comments.

OFII respectfully requests that an additional technical correction relating to the repatriation provision in section 422 of the AJCA be included in the enacted legislation. The correction would clarify that loans from foreign parent companies and their foreign affiliates to related controlled foreign corporations ("CFCs") are not related person indebtedness ("RPI") within the meaning of section 965(b)(3) and that other cash transfers from foreign parent companies and their foreign affiliates to CFCs are not subject to the anti-abuse provision to the RPI limitation contained in the proposed technical corrections legislation. This clarification is essential so that the RPI limitation reduces section 965 benefits solely for the *U.S.*-funded dividends Congress intended and U.S. multinationals with foreign parents are treated in the same manner under section 965 as U.S. multinationals with U.S. owners.

Section 965 is intended to benefit *net* remittances of cash from CFCs to their U.S. shareholders. No net remittance of cash occurs if a CFC dividend is funded by a loan from its U.S. shareholder. To ensure that dividends eligible for the section 965 dividends received deduction are not funded by a U.S. shareholder, Congress included the RPI limitation in section 965(b)(3). The Conference Report for the AJCA is very clear on the RPI limitation's purpose:

This [RPI] rule is intended to prevent a deduction from being claimed in cases in which the U.S. shareholder directly or indirectly (e.g., through a related party) finances the payment of a dividend from a controlled foreign corporation. In such a case, there may be no net repatriation of funds, and thus it would be inappropriate to provide the deduction.

Under the RPI limitation, to the extent that a majority U.S. shareholder has indebtedness outstanding to CFCs at the end of the year of a section 965 election in amounts greater than its indebtedness outstanding to CFCs as of October 3, 2004, the eligible dividend amount is reduced dollar-for-dollar.[1] To define "related person" indebtedness for purposes of the RPI limitation, Congress incorporated by cross-reference the related person definition routinely used for U.S. shareholders and CFCs for subpart F purposes. That definition, in section 954(d)(3), was drafted long before foreign-parented U.S. multinationals were common. The related person definition in section 954(d)(3), read literally, unfortunately encompasses not only majority U.S. shareholders of CFCs but their foreign parents and foreign subsidiaries of those foreign parents as well. The implication of this literal reading, which we believe was unintended, is that loans originating abroad—made by foreign parents and their foreign subsidiaries—to related CFCs are swept into the RPI definition and therefore may reduce section 965 benefits.

As indicated above, the RPI limitation is intended to police CFC borrowing from U.S. persons, not foreign persons. Just as CFC-to-CFC loans are generally excluded from the RPI definition, so too should loans from foreign parents (or their foreign subsidiaries) to CFCs generally be excluded since neither category of loan normally originates in the United States and, therefore, reduces net CFC remittances to the United States.

As drafted, the proposed technical corrections legislation would add an anti-abuse provision to the RPI limitation. The legislation would grant Treasury regulatory authority to prevent the avoidance of the purposes of the RPI limitation, including regulations providing that cash dividends shall not be eligible for section 965 benefits to the extent such dividends are attributable to the direct or indirect transfer (including through the use of intervening entities or capital contributions) of cash or other property from a related person to a CFC. Like loans from foreign parents or their foreign subsidiaries to CFCs, transfers of cash or other property from foreign parents or their foreign subsidiaries to CFCs, as long as not originating in the U.S., should not limit section 965 benefits.[2] The same is true for deemed capital contributions under the *Plantation Patterns*[3] doctrine from foreign parents (or their foreign

[1] The statutory language is: "The amount of dividends which would (but for this paragraph) be taken into account under subsection (a) shall be reduced proportionately for each shareholder by the excess (if any) of—(A) the amount of indebtedness of the controlled foreign corporation to any related person (as defined in section 954(d)(3)) as of the close of the taxable year for which the election under this section is in effect, over (B) the amount of indebtedness of the controlled foreign corporation to any related person (as so defined) as of the close of October 3, 2004. All controlled foreign corporations with respect to which the taxpayer is a United States shareholder shall be treated as 1 controlled foreign corporation for purposes of this paragraph." The initial measurement date may now be the nearest quarter-end to October 3, 2004, by taxpayer election. See Notice 2005–38, section 7.01(b)(vi).

[2] The proposed technical corrections legislation grants ample discretionary authority to the Service and Treasury to address any abuses that may arise involving loans and other property transfers from foreign parents to related CFCs. Specifically, the legislation allows the Service and Treasury to limit section 965 benefits in the case of *indirect* as well as direct funding of CFC dividends by U.S. shareholders. Under this authority, the Service and Treasury may, on a discretionary basis, subject, for example, a foreign parent-to-CFC loan to the RPI limitation if it is funded indirectly by a U.S. shareholder via a loan or distribution from the U.S. shareholder to the lending foreign parent.

[3] Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712 (5th Cir. 1972).

subsidiaries) that have guaranteed CFC debt. Such deemed capital contributions should be considered to go directly from the guarantor to the borrowing CFC and not through the intermediary U.S. parent.[4]

Many foreign-parented multinationals have CFCs with substantial earnings the repatriation of which section 965 was intended to encourage. The domestic reinvestment plan rules (at section 965(b)(4)) ensure that the amount of those repatriated earnings will be spent on permitted investments in the United States. As drafted, the RPI limitation will discourage foreign members of foreign-owned multinational groups from funding related CFC dividends otherwise eligible for section 965 treatment and, thus, thwart the purpose of the repatriation incentive and treat such groups unfairly.

In summary, the technical corrections legislation and accompanying explanatory language, should clarify that, when the parent company of a multinational group to which a CFC belongs is foreign: (1) the RPI limitation generally does not apply when CFC dividend funding is provided by a related foreign person; and (2) funding for CFC dividends may be provided by a related foreign person. The following technical correction language would accomplish this result:

Paragraph (3) of section 965(b) is amended by inserting ", except that no foreign person shall be considered a related person for purposes of this paragraph" after "section 954(d)(3)."

Re: Suggested Technical Correction Regarding Anti-Inversion Legislation (New Section 7874 of the Code)

OFII requests a technical correction to the American Jobs Creation Act of 2004 with regard to new section 7874. We note that the Senate Conference Report included an exception from the application of section 7874 for the direct or indirect acquisition of the properties of a U.S. corporation no class of the stock of which was traded on a public exchange for the preceding four year period. We further note that this exception was not included in the final legislation and understand that you are not entertaining technical corrections to include such an exception. The language that we propose is not intended to include such an exception. We suggest adding the following language in bold italics to section 7874(g):

(g) Regulations.—The Secretary shall provide such regulations as are necessary to carry out this section, including:

(1) regulations providing for such adjustments to the application of this section as are necessary to prevent the avoidance of the purposes of this section, including the avoidance of such purposes through——

(i) the use of related persons, pass-through or other noncorporate entities, or other intermediaries, or

(ii) transactions designed to have persons cease to be (or not become) members of expanded affiliated groups or related persons; and

(2) regulations as are necessary to exempt certain transactions from the application of this section that do not involve the relocation of a top-tier U.S. parent company as a top-tier foreign parent company, including exemptions for internal company restructuring transactions.

Thank you for your consideration of these matters. If your staff has questions about this letter or we can otherwise be of further assistance, please have them call us.

Sincerely,

Todd M. Malan
President & CEO

[4] We recommend the points discussed in the last three sentences of this paragraph be included in the committee reports as examples of how Congress intends the grant of regulatory authority to be exercised by the Service and Treasury.

Subpart F Shipping Coalition
Washington, DC 20001
August 31, 2005

The Honorable William M. Thomas
Chairman
Committee on Ways and Means
1102 Longworth Building
Washington, DC 20515

Dear Mr. Chairman:

We are submitting these comments regarding the technical corrections legislation (H.R. 3376) on behalf of the Subpart F Shipping Coalition and certain additional shipping companies (the "Shipping Coalition"), a group of the United States ("U.S.") controlled foreign-flag shipping companies that are affected by U.S. international taxation policy. The Coalition supports strongly the shipping provisions of the American Jobs Creation Act of 2004 (the "Act").

PROPOSED TECHNICAL CORRECTION RELATING TO REPEAL OF SUBPART F FOREIGN BASE COMPANY SHIPPING INCOME RULES

Section 415 of the Act repealed the subpart F rules with respect to "foreign base company shipping income" to restore the competitiveness of U.S.-owned foreign subsidiaries engaged in shipping operations. Despite the repeal, the income of many of these U.S.-owned foreign shipping companies could (depending on the future shape of Treasury regulations) still become subject to subpart F's rules as "foreign base company services income," thereby frustrating Congress's expressed intent. In a similar fashion, dividends, interest, or gains that would have been foreign base company shipping income under prior law could still become subject to subpart F taxation as "foreign personal holding company income," equally frustrating Congress's intent. We propose that Congress adopt a technical correction, described below, clarifying that (i) income that would have been foreign base company shipping income prior to the Act will not be treated as foreign base company services income and (ii) certain dividends, interest, and gains that would have been foreign base company shipping income under prior law, will not be treated as foreign personal holding company income, after the effective date of the Act.

Background

The American Jobs Creation Act of 2004 (the "Act") represents the most far reaching and significant effort in recent history to restore the international competitiveness of U.S. shipping. This industry has experienced a significant and steady decline over the last twenty-five years, and the nation's technical and support capabilities for this important sector have been eroded as a result. In its 2002 Report on Corporate Inversion Transactions, Treasury specifically identified the current taxation on income earned by U.S.-owned foreign shipping subsidiaries as a competitive disadvantage relative to foreign-owned corporations. The repeal of subpart F's rules concerning foreign base company shipping income in Section 415 of the Act (accompanied by the enactment of a tonnage tax system in subchapter R of the Act) was intended to reverse this decline and to restore the competitiveness of the industry for both economic and national security reasons.

In repealing the foreign base shipping company rules, Congress sought to end the competitive disadvantage of the U.S.-owned shipping subsidiaries that fell within anti-deferral rules of subpart F. The House Ways and Means Committee noted: [1]

In general, other countries do not tax foreign shipping income, whereas the United States imposes immediate U.S. tax on such income. The uncompetitive U.S. taxation of shipping income has directly caused a steady and substantial decline of the U.S. shipping industry. The Committee believes that this provision will provide U.S. shippers the opportunity to be competitive with their tax-advantaged foreign competitors.

Unfortunately, there are several regulations that if applied without deference to the intent of Congress in the Jobs Act could frustrate the realization of the objective of the Jobs Act. The first of those, involving the potential application of Treasury's regulations under Section 883 of the Code, was addressed constructively by Treasury earlier this month. These regulations govern the exclusion from gross income of the income derived from the international operation of ships and aircraft by certain corporations organized in qualified foreign countries. In a recent notice, Treasury stated that the regulation's anti-abuse provision (commonly referred to as the

[1] H. Rpt. 108–548 at 209.

income inclusion test) would be applied without regard to the repeal of the foreign base shipping income rules by the Jobs Act, so that U.S.-owned foreign subsidiaries would not be unfairly penalized under those regulations.

The industry faces a comparable challenge through the potentially inappropriate application of IRS regulations designed to capture services income. In order to compete effectively, U.S. shipping companies provide certain services to their foreign subsidiaries. For instance, while the principal asset generating income is the ship owned by the foreign subsidiary, the U.S. parent often assists in providing or arranging for legal, engineering, marketing and other similar services with respect to the vessel's operation. That should not lead to the taxation of the vessel's operating income under subpart F through the recharacterization of that income as services income. Just like Treasury's approach to the Section 883 regulations, U.S.-owned shipping subsidiaries benefitting from this assistance should not be penalized merely because of the Jobs Act's changes. This is particularly the case where the foreign subsidiary has procured those services through an arms-length arrangement with its parent.

For limited liability and other purposes, shipping companies generally conduct their shipping operations through the use of multiple subsidiary corporations that own and register the vessels. In some cases, these companies are joint ventures where one of the owners is a foreign subsidiary of a U.S.-based shipping company. An additional challenge to the industry is the inappropriate possible application of the foreign personal holding company income rules to dividends, interest, and gains attributable to shipping income that foreign subsidiaries of U.S.-based shipping companies may receive or realize with respect to the lower-tier subsidiaries.

The overall purpose of the Jobs Act was to create jobs in the United States, particularly in sectors where sophisticated and high technology U.S. workers could be competitive in international markets. It would be contrary to the purpose of the Act to tax the ship operating income of foreign corporations under subpart F merely because U.S. workers from affiliated companies are able to provide technical and managerial assistance to those corporations, or because of the fact that ships are held in lower-tier subsidiaries.

Foreign Base Company Services Income

Foreign base company services income of a controlled foreign corporation ("CFC") is defined as income (whether in the form of compensation, commissions, fees, or otherwise) derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services which (1) are performed for or on behalf of any related person and (2) are performed outside the country under the laws of which a CFC is created or organized.[2]

Under Treasury regulations, services subject to the foreign base company services income rules include services performed by a CFC where "substantial assistance" contributing to the performance of such services has been performed by a related person or persons.[3] For this purpose, assistance furnished by a related person or persons to the CFC includes, but is not limited to, direction, supervision, services, know-how, financial assistance (other than contributions to capital), and equipment, material, or supplies.[4] This has the effect of subjecting all of the CFC's operating income to taxation under subpart F merely because of the activities of its parent or other affiliates.

Assistance furnished by a related person or persons to a CFC in the form of direction, supervision, services, or know-how is generally not considered to be "substantial" unless either (1) the assistance provides the CFC with skills which are a principal element in producing the income from the performance of such services by the CFC or (2) the cost to the CFC of the assistance equals 50 percent or more of the total cost to the CFC of performing the services performed by the CFC.[5] Also, assistance furnished by a related person or persons to a CFC in the form of direction, supervision, services, or know-how is not taken into account unless the assistance assists the CFC directly in the performance of the services performed by the CFC.[6] The regulations contain various examples demonstrating the potential application of these rules in cases where a parent corporation provides assistance to its CFC.[7]

Prior to the Act, the Code statutorily provided that foreign base company shipping income would not be considered foreign base company income under any other cat-

[2] Code section 954(e).
[3] Treas. reg. sec. 1.954–4(b)(1)(iv).
[4] Treas. reg. sec. 1.954–4(b)(2)(ii)(a).
[5] Treas. reg. sec. 1.954–4(b)(2)(ii)(b).
[6] Treas. reg. sec. 1.954–4(b)(2)(ii)(e).
[7] See, Treas. reg. sec. 1.954–4(b)(3). See, also, GCM 38065, TAM 8127017, and PLR 8114015.

egory of such income.[8] That provision was repealed as a "conforming amendment" in connection with the Act's repeal of the foreign base company shipping income rules.[9]

Foreign Personal Holding Company Income

The foreign personal holding company income ("FPHCI") rules subject to immediate subpart F taxation a CFC's dividends, interest, royalties, rents, and annuities, and its gains (net of losses) from the sale or exchange of property giving rise to such income.[10] Prior to the Act, dividends, interest, and gains relating to foreign shipping income were treated as foreign base company shipping income and not as foreign personal holding company income.[11]

The Potential Problems

The foreign base company services income rules, as they have been expansively interpreted by the Treasury "substantial assistance" regulations, raise a concern regarding their potential application to CFC shipping income. U.S.-owned shipping operations may have involvement of the U.S. parent corporation in the operation of foreign shipping subsidiaries. This involvement by the parent company is also the case for foreign-based competitors.

Prior to the Act, the Code clearly provided that foreign base company shipping income would not be treated as foreign base company income under any other potentially applicable category of such income. But for the current regulatory provision discussed below, the Act's conforming amendment could open the possibility that shipping income will become subject to immediate subpart F taxation as foreign base company services income in the future.

Current Treasury regulations provide that foreign base company services income does not include, for taxable years beginning after December 31, 1975, foreign base company shipping income (as determined under Treas. reg. sec. 1.954–6).[12] However, there is a concern that in light of the "conforming amendment" discussed above, the Treasury Department may consider modifying this regulatory provision.

This concern results from the fact that international shipping operations are generally global in scope, and may involve the services of many related and unrelated companies. Vessel owners typically employ the assistance of brokers, agents, technical managers and economic managers. They should not be prohibited from employing the assistance of related U.S. companies that may be engaged in those services, since the purpose of the Jobs Act was to restore those capabilities in the United States. Obviously, the goal of Congress in repealing the subpart F shipping income rules would be frustrated if U.S. shipping companies remained subject to immediate subpart F taxation on their shipping income under some other provision of the foreign base company income rules.

The FPHCI rules may present a problem with respect to foreign shipping income earned through lower-tier foreign subsidiaries. The use of lower-tier subsidiaries for conducting shipping operations is typical in the industry. When lower-tier foreign subsidiaries pay to the CFC that owns them dividends or interest attributable to shipping income, the FPHCI rules, absent a technical correction, could, in certain circumstances, cause the dividend or interest income to become subject to immediate federal income taxation even though it has not been paid to the ultimate U.S. parent. Similarly, when the CFC sells or disposes of a lower-tier subsidiary, the FPHCI rules could subject the gain to immediate federal income taxation. It should be noted that these foreign personal holding company income problems would not arise if foreign shipping operations were conducted through a single CFC entity rather than through lower-tier subsidiaries. Obviously, the goal of Congress, in repealing the subpart F shipping income rules would also be frustrated if U.S. shipping companies remained subject to immediate taxation under the FPHCI rules because of the corporate structure they have typically used.

[8] Code section 954(b)(6) (as in effect prior to the Act).
[9] Act section 415(c)(2)(b).
[10] Code section 954(c)(1)(A), (B).
[11] Code section 954(f) (as in effect before the Act) provided that foreign base company shipping included:

(1) dividends and interest received from a foreign corporation in respect of which taxes are deemed paid under section 902, and gain from the sale, exchange, or disposition of stock or obligations of such foreign corporation to the extent that such dividends, interest and gains are attributable to foreign base company shipping income, and

. . . Except as provided in paragraph (1), such term shall not include any dividend or interest income which is foreign personal holding company income (as defined in subsection (c)).

[12] Treas. reg. sec. 1.954–4(d)(3).

The proposed technical correction below would clarify that income that a CFC can show would have been foreign base company shipping income prior to the Act, will not be treated as foreign base company services income. This change will protect the operating income of the CFC from recharacterization. It is without prejudice to the ability of the Service by regulation or otherwise to require the related U.S. company to recognize income reflecting the value of any assistance it may provide to its foreign shipping subsidiary. The proposed technical correction would also clarify that dividend, interest, and gain income that would have been foreign base company shipping income under prior law will not be treated as foreign personal holding company income.

Draft Technical Correction

AMENDMENT RELATED TO SECTION 415 OF THE AMERICAN JOBS CREATION ACT OF 2004——

Section 954(b) is amended by adding at the end thereof the following new paragraph:

(7) Special Rules for Certain Shipping Income.—Income of a corporation that would have been foreign base company shipping income under paragraph (4) of subsection (a) (as in effect before its repeal in the American Jobs Creation Act of 2004) shall not be considered foreign base company income of such corporation under paragraph (3) of subsection (a) and income that would have been foreign base company shipping income under paragraph (1) of subsection (f) (as in effect before its repeal in the American Jobs Creation Act of 2004) shall not be considered foreign base company income under paragraph (1) of subsection (a).

PROPOSED TECHNICAL CORRECTION RELATING TO INCENTIVES TO REINVEST FOREIGN EARNINGS IN THE UNITED STATES

The Act creates a one-time opportunity for U.S. companies to repatriate earnings from their foreign subsidiaries at a reduced rate of tax. In order to qualify for this one-time opportunity, U.S. companies must utilize such repatriated earnings as part of a "domestic reinvestment plan" designed to encourage domestic employment. With the exception of certain related party indebtedness, increased leverage is an accepted method of raising funds to facilitate the repatriation of the benefited foreign earnings. Certain foreign corporations engaged in international shipping, however, are severely limited in the amount of indebtedness that they may efficiently incur due to the application of an historic tax provision that has little, if any, further relevance. We propose that Congress adopt a technical correction, described below, clarifying that distributed amounts related to previously excluded subpart F income withdrawn from foreign base company shipping operations will qualify for the reduced tax rate, thereby expanding the potential domestic reinvestment of foreign earnings, in accordance with Congressional intent.

Background

Domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income generally is deferred, and U.S. tax is imposed on such income only when repatriated. However, under certain anti-deferral rules, the domestic parent corporation may be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. One of the main anti-deferral provisions in this context is the CFC rules of subpart F. The U.S. tax owed on foreign-source income, whether earned directly by the domestic corporation, repatriated as a dividend from a foreign subsidiary, or included in income under the anti-deferral rules, may be reduced through foreign tax credits, if any.[13]

Dividends received by a domestic corporation from its foreign corporate subsidiaries are ordinarily not eligible for a dividends-received deduction. Under section 965 of the Code, however, certain cash dividends received by a United States corporate shareholder of a CFC which are to be reinvested in the United States by such shareholder are eligible for an 85-percent dividends-received deduction.[14] Section 965 of the Code was introduced by the Act as an incentive to repatriate and reinvest domestically foreign earnings that would otherwise likely remain offshore. The de-

[13] Code sections 901, 902, 960, 1291(g).
[14] Code section 965(a)(1).

duction provided by section 965 of the Code is available only for a limited time.[15] The deduction does not apply to items that are not included in gross income as dividends, such as subpart F inclusions or deemed repatriations under section 956 of the Code. Further, cash dividends excluded from gross income under section 959(a) of the Code are ineligible for the 85-percent dividends-received deduction of section 965. The deduction is allowed, however, for cash distributions excluded from gross income under section 959(a) of the Code to the extent of subpart F income resulting from dividends received by the CFC or a lower tier CFC.[16] Without this exception, a U.S. shareholder of a second tier or lower CFC would generally be unable to avail itself of section 965 of the Code simply because the distributions themselves generated subpart F income.

The Problem

U.S. shareholders of foreign shipping companies who wish to reinvest their foreign earnings in the United States under section 965 of the Code may be prohibited from doing so because a distribution of those earnings can result in non-qualifying subpart F income. As described below, the subpart F income can result from a reduced "net investment in qualified shipping assets" which may occur as a result of this dividend.[17] In such a case, the distribution is excluded from gross income under section 959(a) of the Code and will not benefit from the 85-percent dividends-received deduction provided by section 965.

For taxable years beginning after 1975 and before 1987, the subpart F income of a CFC generally did not include foreign base company shipping income to the extent that such shipping income was reinvested during the taxable year in certain qualified shipping investments.[18] To the extent that, in a subsequent year, a net decrease in qualified shipping investments occurred, however, the amount of previously excluded subpart F income equal to such decrease was itself considered subpart F income.[19] For taxable years beginning after 1986, the exclusion for reinvested foreign base company shipping income was repealed.[20] The provisions relating to the pre-1987 net investment in qualified shipping assets, however, were retained. These rules continue to apply even after the Act's repeal of the subpart F rules applicable to foreign base company shipping income.

As a consequence of these rules, qualified shipping investments are a category of earnings permanently invested abroad which, uniquely, are potentially ineligible for the benefits of section 965 of the Code if repatriated. Further, and again uniquely, a CFC which maintains such investments may be prevented from borrowing from third-party sources to fund a dividend which qualifies under section 965 of the Code, since such a borrowing will, post-dividend, result in a decrease in the amount of such investments. We believe that this result was not intended by Congress, since it is caused by the residue of a statutory scheme which was repealed almost 20 years ago and which has been largely forgotten since. As a result, we believe that it is an appropriate candidate for a technical correction.

The proposed technical correction below clarifies that a United States shareholder of a CFC will be allowed to qualify for the 85-percent dividends-received deduction for cash distributions that are excluded from gross income under section 959(a) of the Code to the extent of any amount included in the United States shareholder's income for the taxable year under the rules relating to the inclusion of previously excluded subpart F income withdrawn from foreign base company shipping operations (section 951(a)(1)(A)(iii) of the Code). It tracks the mechanics of existing section 965 of the Code, which addresses a similar problem which could have arisen in the case of dividends paid up a multi-tiered chain of CFCs.

Because of the short remaining time to bring dividends back under section 965 (i.e., until December 31, 2005), we would urge an extension through December 31, 2006, of the period to repatriate earnings covered by this shipping income technical correction.

Section 965 Draft Technical Correction

AMENDMENT RELATED TO SECTION 422 OF THE AMERICAN JOBS CREATION ACT OF 2004

Section 965(a)(2) is amended to read as follows:

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[15] Code section 965(f).
[16] Code section 965(a)(2).
[2] Code section 955; Treas. Reg. sec. 1.955A.
[18] Former Code section 954(b)(2).
[19] Code section 955(a).
[20] Section 1221(c)(1) of the Tax Reform Act of 1986.

(2) DIVIDENDS PAID INDIRECTLY FROM CONTROLLED FOREIGN CORPORATIONS AND PREVIOUSLY EXCLUDED SUBPART F INCOME WITHDRAWN FROM FOREIGN BASE COMPANY SHIPPING OPERATIONS.—If, within the taxable year for which the election under this section is in effect, a United States shareholder receives a cash distribution from a controlled foreign corporation which is excluded from gross income under section 959(a), such distribution shall be treated for purposes of this section as a cash dividend to the extent of

(A) *any amount included in income* by such United States shareholder under section 951(a)(1)(A) as a result of any cash dividend during such taxable year to——

(i) such controlled foreign corporation from another controlled foreign corporation that is in a chain of ownership described in section 958(a), or

(ii) any other controlled foreign corporation in such chain of ownership, but only to the extent of cash distributions described in section 959(b) which are made during such taxable year to the controlled foreign corporation from which such United States shareholder received such distribution; and

(B) any amount included in income *for such taxable year by such United States shareholder under section 951(a)(1)(A)(iii) (relating to previously excluded subpart F income withdrawn from foreign base company shipping operations).*

An amount included in income under section 951(a)(1)(A)(iii) in respect of a controlled foreign corporation in a chain of ownership described in section 958(a) other than the controlled foreign corporation from which the United States shareholder receives the cash distribution shall be taken into account for purposes of subparagraph (B) only to the extent of cash distributions described in section 959(b) which are made during such taxable year through such chain of ownership to the controlled foreign corporation from which the United States shareholder receives the cash distribution.

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Tailored Clothing Association
Washington, DC 20036
August 22, 2005

The Honorable Clay Shaw
Chairman
Subcommittee on Trade
Committee on Ways and Means
U.S. House of Representatives
1104 Longworth House Office Building
Washington, DC 20515

Dear Chairman Shaw:

On behalf of the Tailored Clothing Association, I would request that the Committee consider making a technical corrections in Title V of P.L. 108–429. The Association represents the interests of the men's and boys' suit industry and has worked with the Committee on tariff relief measures for imported worsted wool fabrics.

Last year Congress extended the wool tariff relief program by two additional years as part of Miscellaneous Trade and Technical Corrections Act of 2004 (Title V of P.L. 108–429). The original tariff relief would have ended at the end of 2005. However, the sunset date for two tariff line (9902.51.15 and 9902.51.16) were unintentionally extended by only one year (through 12/12/2006). Other tariff lines extended as part of the wool relief extension package received the proper extension through the end of 2007.

The Conference Committee Report language describing the extension clearly indicates that the tariff lines were to be extended by two years. In addition, Senator Baucus inserted a Senate floor statement into the Congressional Record flagging the fact that a technical corrections was needed for purposes of this tariff line. The wool tariff relief package contains several tariff lines, and all items in the package have always had the same sunset dates.

We would appreciate consideration of making this technical corrections this year, so that pricing and fabric selection decisions, which are made far in advance of actual imports, can properly factor potential duty rate levels.

We appreciate your consideration of our request.

David Starr
Counsel

Milan, Michigan 48160
August 31, 2005

Honorable John D. Dingell
U.S. House of Representatives
15th District, Michigan
19855 W. Outer Drive
Suite 103–E
Dearborn, MI 48124

Dear Representative Dingell:

I had the good fortune of meeting with you in person during an open meeting in Dearborn, Michigan on Tuesday, August 30, 2005. The purpose of my letter is to better inform you of the specifics regarding a rather large AMT tax debt that I incurred on "phantom" gains due to the application of the Alternative Minimum Tax to incentive stock options (ISOs). This letter also comes as a result of your personal recommendation during our brief meeting.

The issue with the AMT and ISOs is very complicated. The table below has been added to assist in detailing the financial woes that myself, and many others, have learned about "the hard way."

In 2000, I took out a Home Equity loan to cover costs associated with the exercise of 13,166 stocks options with my current employer. At the time of the sale, the stock was trading at $7.50. My exercise price was $3.10 per share, and I chose to "hold" the stocks for a minimum of one year in order to take advantage of the lower capital gains tax rate of 20%. What I did not know at the time of exercise was that my unrealized, or "phantom" gain of $57,930.40 was subject to a form of taxation (the AMT) even though the stocks were not actually sold. As such, I incurred a very large, unexpected tax liability when my 2000 tax returns were completed. At this point, I also "earned" an AMT credit of $12,403 which could be applied to future taxes, or at least that was what I thought.

Unfortunately, the stock price continued to fall and in 2004 I actually sold the securities and realized a gain of $2,399.00. This was a far cry from the "phantom" gain of $57,930.40 which formed the basis of my AMT in 2000. While preparing for my 2004 tax return, I assumed that the complete $12,403 tax credit would be refunded to me based upon the fact that my realized gain was only a mere 5% of the "phantom" gain. However, after much consultation with my tax advisor, I soon learned that this event (the actual sale of the securities) was not an adequate event to trigger the complete release of the tax credit per our current tax code. The resultant AMT credit carried forward was reduced to $11,397.00. Further, my research has shown me that the AMT remaining credit is not likely to be refunded over the course of my life using conventional means.

Year		**2000**
Number of Stock Options Exercised		13,166
Exercise Price	$	3.10
Cost Basis	**$**	**40,814.60**
Stock Value on Day of Exercise	$	7.50
"Phantom" Gross Proceeds	$	98,745.00
"Phantom" Gain Subject to AMT	***$***	***57,930.40***
Resultant AMT Due	**$**	**12,403.00**

Year		**2004**
Sold Stocks - Actual Gain	$	2,399.00
AMT Credit Carried Forward	**$**	**11,397.00**

I would like to ask for your active support and co-sponsorship of H.R. 3385. This important legislation was recently introduced by Reps. Johnson (TX), Neal, McCrery, Jefferson, Ramstad, Lofgren, Shaw, Honda and Johnson (CT), to provide relief for taxpayers subjected to unfair and unjust tax treatment due to the AMT treatment ISOs. In addition to unfairly affecting me, this serious problem has impacted many employees of small and large companies across America, often resulting in taxes up to and exceeding 300 percent of these employees' annual salaries. Workers are being forced to pay tens of thousands, hundreds of thousands, and even millions of dollars in tax overpayments on income they will never receive.

Please join the groundswell of support for remedying this serious injustice through this ISO AMT legislation. This bi-partisan effort is building support in Congress, the Press, Corporate America, the Taxpayer Advocate's office. Grassroots organizations like the ReformAMT www.reformamt.org and the Coalition for Tax Fairness www.fair-iso.org are actively supporting this important legislation, and may be contacting your office to secure your support.

Again, it was a pleasure to meet with you and have the opportunity to touch on this issue one on one. I am hopeful that you will see the injustice with the portion of the tax code affecting ISOs and take the appropriate countermeasures. Should you have any additional questions or comments regarding my testimony, please feel free to contact me at 734–681–1080

Best Regards,

John Terech

Williams & Jensen, LLC
Washington, DC 20036
August 19, 2005

The Honorable William Thomas, Chairman
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515–6348

Dear Chairman Thomas:

On behalf of potential applicants for allocations of tax-exempt financing authority under section 701 of H.R. 4520, the *American Jobs Creation Act of 2004* (P.L. 108–357) I am writing to comment on the proposed legislation to make technical changes in the tax code, H.R. 3376, the *Tax Technical Corrections Act of 2005*. I appreciate the opportunity to raise the following points with the Ways and Means Committee about the potential inclusion of a technical correction related to the "Brownfields Demonstration Program for Qualified Green Building and Sustainable Design Projects" in H.R. 4520, the *American Jobs Creation Act of 2004*.

Background

Section 701 of the *American Jobs Creation Act of 2004* (P.L. 108–357) (hereinafter the "Jobs Act"), creates a new category of exempt-facility bond under IRC section 142, the qualified green building and sustainable design project bond ("qualified green bond").

The qualified green bond legislation sets an aggregate limitation of $2 billion of qualified green bonds that the Secretary may allocate to qualified green building and sustainable design projects. Projects were to be nominated within 6 months of enactment, with allocations made within 60-days thereafter. The IRS extended this deadline for applications in Notice 2005–28 until the date that is 120 days after the date it publishes guidance on the subject. The authority to issue qualified green bonds terminates after September 30, 2009.

Under the new IRC section 142(l)(4)(A)(v), the tax benefits of qualified green bonds are to be allocated toward financing one or more of the following:

(I) The purchase, construction, integration, or other use of energy efficiency, renewable energy, and sustainable design features of the project.

(II) Compliance with certification standards cited under [Section 142(l)(4)(A)(i)] (i.e., the United States Green Building Council's LEED certification).

(III) The purchase, remediation, and foundation construction and preparation of the brownfields site.

The inclusion of specific first-stage development costs in the language of the qualified green bond legislation clearly contemplated that the qualified green bond proceeds would be used for such purposes. All of the projects that worked with the Committees in developing the demonstration program had already acquired and remediated their brownfields sites.

Reimbursement Regulations

Under current federal regulations (§ 1.150–2), the proceeds of private activity bonds described in section 142 (including qualified green bonds) may be used to reimburse an issuer for capital expenditures incurred prior to the date of issuance of such bonds ("original expenditures"), provided that, not later than 60 days after the payment of the original expenditures, the issuer adopted an official intent resolution indicating that it reasonably expected to reimburse itself for such original expenditures with the proceeds of a subsequent bond issue. In addition, under the current regulations, the issuer must allocate (in writing) the proceeds of its bonds to the original expenditures within 18 months of the later of (i) the date the original expenditure is paid or (ii) the date the project is placed in service—but in no event more than three years (five years in the case of certain long-term construction projects) after the original expenditure is paid. The regulations provide certain minor exceptions to these rules.

In the case of a refinancing of interim debt for an exempt facility, current federal regulations (§ 1.142–4) provide that the foregoing rules are applied to the use of the proceeds of the interim obligations, except that if the interim obligation is not a state or local bond (e.g., a construction loan from a bank to the developer), the foregoing rules are applied to the refunding bonds.

Impossibility to Comply with Regulations

In the case of potential qualified green bonds projects already underway, a significant amount of the expenditures that are required to make such projects eligible for an allocation from the Secretary under the qualified green bond legislation—including, but not limited to, the expenditures relating to the purchase, remediation and preparation of the brownfield sites—were incurred prior to the adoption of the qualified green bond legislation by Congress in October 2004. However, prior to the adoption of the qualified green bond legislation by Congress, an issuer could not have adopted an official intent resolution relating to expenditures for a qualified green bond project.

Absent a technical correction, the Internal Revenue Service is unwilling to waive the requirement for an official intent resolution or the timing rules in connection with the reimbursement of expenditures related to a qualified green bonds project. Therefore, absent a technical correction to the qualified green bond legislation, the potential qualified green bonds projects will not be eligible for the reimbursement of certain expenditures which Congress clearly envisioned as being eligible for qualified green bond financing under section 142(l) when it adopted the qualified green bonds legislation.

Program Incentives Are Furthered By Refinancing

In addition, the reimbursement regulations are intended to prevent the replacement of taxable financing with tax-exempt financing without changing the character of the project financed. In the instant case, such a result is impossible. Any project awarded tax-exempt financing authority must make significant investments in nonconventional energy sources. The projects awarded bonding authority must, in the aggregate:

- Reduce peak rate of consumption of electricity from the grid by 150 megawatts through the use of renewable energy, on-site power generation, and energy efficiency—equivalent to the peak rate of power consumption for approximately 20 million square feet of commercial office space or approximately 60,000 homes;
- Install 900,000 square feet of solar panels, or more than 20 acres;
- Install 10.9 megawatts of fuel cell ***electric*** generation, which would represent a 27% increase in installed fuel cell electricity generating capacity in U.S.; and
- Through the use of renewable energy, on-site power generation, and energy efficiency, reduce daily sulfur dioxide emissions by at least 10 tons per day compared to coal generation power.

The estimated cost of these investments alone, including design, purchase, and installation exceeds $265 million. Thus, the cost of deploying these technologies exceeds the financing benefits of $2 billion in tax-exempt financing. The mandatory expenditures for qualification are rigorous and substantial. The capacity to manage cash flow for these projects given the tremendous costs of the technologies involved is important.

Finally, the projects must demonstrate that the net tax benefit of the tax-exempt financing was used for the purposes described above (including brownfields remediation). ***In essence, Congress inserted into the Code a specific rule that displaces the need for a conflicting regulatory requirement that restricts refinancings to avoid windfall net tax benefits from tax exempt bonds.***

Congress and the Implementing Rules Envision a Look Back

As stated above the projects that worked on developing the language of the demonstration program described their progress in detail to the tax writing Committees. Even the implementing rules under IRS Notice 2005–48 reflect the fact that projects envisioned to compete for allocation had already been well underway. For example, the Code provision requires state and local government resources of at least $5 million to be contributed towards the project to become eligible. The Notice allows such resources to be counted to the extent provided "at any time during the period beginning on October 22, 2001 (three years prior to the enactment of the Act). . . ."

The Jobs Act apparently does not provide sufficient guidance for Treasury/IRS to determine how Congress intended the reimbursement regulations to interplay with projects already underway. Without such guidance, projects that have already made significant expenditures and yet have to alter construction and investment plans are disadvantaged as opposed to early stage projects that have more flexibility in timing a tax-exempt issue to maximize cash flow needs. In Title VIII (entitled "Energy Policy Tax Incentives") of the recently enacted Domenici-Barton Energy Policy Act of 2005 (H.R. 6, Signed by the President on August 8, 2005, Public Law number unavailable), Congress provided more specific guidance on how the IRS should treat the refinancing rules with respect to newly authorized category of tax credit bonds, Clean Renewable Energy Bonds. The new IRC section 54(d)(2)(B) specifically discusses conditions under which the bonds may and may not be used to refinance existing indebtedness. No similar guidance is included in the Jobs Act for the green bonds provision.

Extension of Time

Because the IRS has delayed the date for submission of project nominations beyond the originally contemplated statutory time frames, the deadline for issuing qualified green bonds should be extended by one year to ensure that the projects can reasonably utilize the qualified green bonds. The overall maximum amount of bonds that may be issued will not be changed, so the scope and revenue impact will not increase.

Technical Correction Language

To address these technical correction issues related to the reimbursement of expenditures for potential qualified green bonds projects incurred prior to the issuance of qualified green bonds, the following should be enacted as an off-Code provision:

"For purposes of the reimbursement allocation regulations (including Reg. §§ 1.142–4 and 1.150–2), a project described in section 142(l) shall be deemed to be a long-term construction project as described in Reg. § 1.150–2(d)(2)(iii) and to have had an official intent resolution which satisfies the requirements of Reg. § 1.150–2 covering the project adopted by an issuer prior to the date of the earliest expenditure of any cost described in section 142(l)(4)(A)(v)."

To address the reduced time in which a project will have to secure financing as a result of current implementation delays, and to maintain the five year window to issue bonds as originally contemplated by the qualified green bonds legislation, the following Code amendment should be enacted:

"Section 142(l)(8) and (9) are amended by striking '2009' each place it appears and inserting in lieu thereof '2010'."

We appreciate the Committee's consideration of our request for technical corrections, and we stand prepared to provide additional information as you may request.

David Starr

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