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SENATE

REPORT
107–211

# CARE ACT OF 2002

JULY 16, 2002.—Ordered to be printed

Mr. BAUCUS, from the Committee on Finance,
submitted the following

# R E P O R T

[To accompany H.R. 7]

The Committee on Finance, to which was referred the bill (H.R. 7) to provide incentives for charitable contributions by individuals and businesses, to improve the effectiveness and efficiency of government program delivery to individuals and families in need, and to enhance the ability of low-income Americans to gain financial security by building assets, having considered the same, report favorably thereon with an amendment in the nature of a substitute and recommend that the bill as amended do pass.

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99–010

# I. LEGISLATIVE BACKGROUND

*Overview*

H.R. 7 (the "Community Solutions Act of 2001") was passed by the House of Representatives on July 19, 2001. H.R. 7 was referred to the Senate Committee on Finance on July 19, 2001. The Senate Committee on Finance marked up the bill on June 13, 2002, and June 18, 2002. The bill, as amended by an amendment in the nature of a substitute, was ordered reported on June 18, 2002 by voice vote.

*Committee hearings*

The Committee held a hearing regarding encouraging charitable giving on March 14, 2001.

The Committee held a hearing on March 21, 2002, regarding the proliferation of tax shelters. At such hearing, notice was given that the Committee intended to take action to curtail the benefits of inversion transactions

# II. EXPLANATION OF THE BILL

## Title I. Charitable Giving Incentives

### A. Charitable Deduction for Nonitemizers

(Sec. 101 of the bill and secs. 63 and 170 of the Code)

#### PRESENT LAW

In computing taxable income, an individual taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and up to the fair market value of property contributed to a charity described in section 501(c)(3)[1] or a Federal, State, or local governmental entity. The deduction also is allowed for purposes of calculating alternative minimum taxable income.

The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.[2]

A taxpayer who takes the standard deduction (i.e., who does not itemize deductions) may not take a separate deduction for charitable contributions.[3]

A payment to a charity (regardless of whether it is termed a "contribution") in exchange for which the donor receives an economic benefit is not deductible, except to the extent that the donor can demonstrate that the payment exceeds the fair market value of the benefit received from the charity. To facilitate distinguishing charitable contributions from purchases of goods or services from charities, present law provides that no charitable contribution deduction is allowed for a separate contribution of $250 or more unless the donor obtains a contemporaneous written acknowledgement of the contribution from the charity indicating whether the charity provided any good or service (and an estimate of the value of any such good or service) to the taxpayer in consideration for the contribution.[4] In addition, present law requires that any charity that receives a contribution exceeding $75 made partly as a gift and partly as consideration for goods or services furnished by the charity (a "quid pro quo" contribution) is required to inform the contributor in writing of an estimate of the value of the goods or services furnished by the charity and that only the portion exceeding the value of the goods or services is deductible as a charitable contribution.[5]

Under present law, total deductible contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer's contribution base, which is the taxpayer's

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[1] All section references are to the Internal Revenue Code of 1986, unless otherwise indicated.
[2] Secs. 170(b) and (e).
[3] Sec. 170(a). The Economic Recovery Tax Act of 1981 adopted a temporary provision that permitted individual taxpayers who did not itemize income tax deductions to claim a deduction from gross income for a specified percentage of their charitable contributions. The maximum deduction was $25 for 1982 and 1983, $75 for 1984, 50 percent of the amount of the contribution for 1985, and 100 percent of the amount of the contribution for 1986. The nonitemizer deduction terminated after 1986.
[4] See. 170(f)(8).
[5] Sec. 6115.

adjusted gross income for a taxable year (disregarding any net operating loss carryback). To the extent a taxpayer has not exceeded the 50-percent limitation, (1) contributions of capital gain property to public charities generally may be deducted up to 30 percent of the taxpayer's contribution base, (2) contributions of cash to private foundations and certain other charitable organizations generally may be deducted up to 30 percent of the taxpayer's contribution base, and (3) contributions of capital gain property to private foundations and certain other charitable organizations generally may be deducted up to 20 percent of the taxpayer's contribution base.

Contributions by individuals in excess of the 50-percent, 30-percent, and 20-percent limit may be carried over and deducted over the next five taxable years, subject to the relevant percentage limitations on the deduction in each of those years.

In addition to the percentage limitations imposed specifically on charitable contributions, present law imposes a reduction on most itemized deductions, including charitable contribution deductions, for taxpayers with adjusted gross income in excess of a threshold amount, which is indexed annually for inflation. The threshold amount for 2002 is $137,300 ($68,650 for married individuals filing separate returns). For those deductions that are subject to the limit, the total amount of itemized deductions is reduced by three percent of adjusted gross income over the threshold amount, but not by more than 80 percent of itemized deductions subject to the limit. Beginning in 2006, the overall limitation on itemized deductions phases-out for all taxpayers. The overall limitation on itemized deductions is reduced by one-third in taxable years beginning in 2006 and 2007, and by two-thirds in taxable years beginning in 2008 and 2009. The overall limitation on itemized deductions is eliminated for taxable years beginning after December 31, 2009; however, this elimination of the limitation sunsets on December 31, 2010.

### REASONS FOR CHANGE

The Committee recognizes that the Administration believes that providing a charitable deduction for taxpayers who do not itemize deductions will result in an increase in charitable giving. In addition, the Committee appreciates that the charitable deduction is an important part of the President's faith-based initiative. The proposal is for a two-year period. To provide Congress adequate information in considering extending the proposal, the Committee requires the Secretary of the Treasury to submit a report on the effectiveness of the provision. The report should consider the extent to which charitable giving has increased, the burdens of complexity to taxpayers and the impact on tax compliance.

### EXPLANATION OF PROVISION

In the case of an individual taxpayer who does not itemize deductions, the provision allows a "direct charitable deduction" from adjusted gross income for charitable contributions paid in cash during the taxable year. This deduction is allowed in addition to the standard deduction. The deduction is available only for that portion of contributions actually made during the year that in the aggregate exceed $250 ($500 in the case of a joint return). The maximum deduction is $250 ($500 in the case of a joint return). Contributions that are below the minimum amount or that exceed the maximum deduction may not be carried over for purposes of a subsequent taxable year's calculation of the direct charitable deduction. Under the provision, an individual is not entitled to a charitable deduction for the first $250 of cash contributions made during the tax year, is entitled to a deduction on a dollar-for-dollar basis for contributions of $251 to $500 (e.g., a $1 contribution deduction in the case of $251 of contributions, and a $250 deduction in the case of $500 of contributions), and is not entitled to a deduction for contributions exceeding $500.

The provision does not alter present-law rules regarding the carryover of contributions to or from a taxable year, including a taxable year in which the taxpayer elects the standard deduction. The direct charitable deduction generally is subject to the tax rules normally governing charitable contribution deductions, such as the substantiation requirements. The deduction is allowed in computing alternative minimum taxable income.

The provision requires the Secretary of the Treasury to complete a study by December 31, 2003, of the effect of the provision on increased charitable giving, and of taxpayer compliance, for example, by comparing compliance by taxpayers who itemize their charitable contributions with compliance by those who claim the direct charitable deduction. The Secretary shall report on the study to the Committee on Finance of the Senate and the Committee on Ways and Means of the House of Representatives.

EFFECTIVE DATE

The direct charitable deduction is effective for taxable years beginning after December 31, 2001, and before January 1, 2004. The Treasury study is required by December 31, 2003.

## B. Tax-Free Distributions From Individual Retirement Arrangements for Charitable Purposes

(Sec. 102 of the bill and secs. 408 and 6034 of the Code)

PRESENT LAW

*In general*

If an amount withdrawn from a traditional individual retirement arrangement ("IRA") or a Roth IRA is donated to a charitable organization, the rules relating to the tax treatment of withdrawals from IRAs apply to the amount withdrawn and the charitable contribution is subject to the normally applicable limitations on deductibility of such contributions.

*Charitable contributions*

In computing taxable income, an individual taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and up to the fair market value of property contributed to a charity described in section 501(c)(3) or a Federal, State, or local governmental entity. The deduction also is allowed for purposes of calculating alternative minimum taxable income.

The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.[6]

A taxpayer who takes the standard deduction (i.e., who does not itemize deductions) may not take a separate deduction for charitable contributions.[7]

A payment to a charity (regardless of whether it is termed a "contribution") in exchange for which the donor receives an economic benefit is not deductible, except to the extent that the donor can demonstrate that the payment exceeds the fair market value of the benefit received from the charity. To facilitate distinguishing charitable contributions from purchases of goods or services from charities, present law provides that no charitable contribution deduction is allowed for a separate contribution of $250 or more unless the donor obtains a contemporaneous written acknowledgement of the contribution from the charity indicating whether the charity provided any good or service (and an estimate of the value of any such good or service) to the taxpayer in consideration for the contribution.[8] In addition, present law requires that any charity that receives a contribution exceeding $75 made partly as a gift and partly as consideration for goods or services furnished by the charity (a "quid pro quo" contribution) is required to inform the contributor in writing of an estimate of the value of the goods or services furnished by the charity and that only the portion exceeding the value of the goods or services is deductible as a charitable contribution.[9]

Under present law, total deductible contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer's contribution base, which is the taxpayer's adjusted gross income for a taxable year (disregarding any net operating loss carryback). To the extent a taxpayer has not exceeded the 50-percent limitation, (1) contributions of capital gain property to public charities generally may be deducted up to 30 percent of the taxpayer's contribution base, (2) contributions of cash to private foundations and certain other charitable organizations generally may be deducted up to 30 percent of the taxpayer's contribution base, and (3) contributions of capital gain property to private foundations and certain other charitable organizations generally may be deducted up to 20 percent of the taxpayer's contribution base.

Contributions by individuals in excess of the 50-percent, 30-percent, and 20-percent limit may be carried over and deducted over the next five taxable years, subject to the relevant percentage limitations on the deduction in each of those years.

In addition to the percentage limitations imposed specifically on charitable contributions, present law imposes a reduction on most itemized deductions, including charitable contribution deductions, for taxpayers with adjusted gross income in excess of a threshold amount, which is indexed annually for inflation. The threshold

[6] Secs. 170(b) and (e).

[7] Sec, 170(a). The Economic Recovery Tax Act of 1981 adopted a temporary provision that permitted individual taxpayers who did not itemize income tax deductions to claims a deduction from gross income for a specified percentage of their charitable contributions. The maximum deduction was $25 for 1982 and 1983, $75 for 1984, 50 percent of the amount of the contribution for 1985, and 100 percent of the amount of the contribution for 1986. The nonitemizer deduction terminated after 1986.

[8] Sec. 170(f)(8).

[9] Sec. 6115.

amount for 2002 is $137,300 ($68,650 for married individuals filing separate returns). For those deductions that are subject to the limit, the total amount of itemized deductions is reduced by three percent of adjusted gross income over the threshold amount, but not by more than 80 percent of itemized deductions subject to the limit. Beginning in 2006, the overall limitation on itemized deductions phases-out for all taxpayers. The overall limitation on itemized deductions is reduced by one-third in taxable years beginning in 2006 and 2007, and by two-thirds in taxable years beginning in 2008 and 2009. The overall limitation on itemized deductions is eliminated for taxable years beginning after December 31, 2009; however, this elimination of the limitation sunsets on December 31, 2010.

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity (e.g., a remainder) while also either retaining an interest in that property (e.g., an income interest) or transferring an interest in that property to a noncharity for less than full and adequate consideration.[10] Exceptions to this general rule are provided for, among other interests, remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, and present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property.[11] For such interests, a charitable deduction is allowed to the extent of the present value of the interest designated for a charitable organization.

*IRA rules*

Within limits, individuals may make deductible and nondeductible contributions to a traditional IRA. Amounts in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal represents a return of nondeductible contributions). Individuals also may make nondeductible contributions to a Roth IRA. Qualified withdrawals from a Roth IRA are excludable from gross income. Withdrawals from a Roth IRA that are not qualified withdrawals are includible in gross income to the extent attributable to earnings. Includible amounts withdrawn from a traditional IRA or a Roth IRA before attainment of age 59½ are subject to an additional 10-percent early withdrawal tax, unless an exception applies.

If an individual has made nondeductible contributions to a traditional IRA, a portion of each distribution from an IRA is nontaxable, until the total amount of nondeductible contributions has been received. In general, the amount of a distribution that is nontaxable is determined by multiplying the amount of the distribution by the ratio of the remaining nondeductible contributions to the account balance. In making the calculation, all traditional IRAs of an individual are treated as a single IRA, all distributions during any taxable year are treated as a single distribution, and the value of the contract, income on the contract, and investment in the contract are computed as of the close of the calendar year.

[10] Secs. 170(f), 2055(e)(2), and 2522(c)(2).
[11] Sec. 170(f)(2).

In the case of a distribution from a Roth IRA that is not a qualified distribution, in determining the portion of the distribution attributable to earnings, contributions and distributions are deemed to be distributed in the following order: (1) regular Roth IRA contributions; (2) taxable conversion contributions;[12] (3) nontaxable conversion contributions; and (4) earnings. In determining the amount of taxable distributions from a Roth IRA, all Roth IRA distributions in the same taxable year are treated as a single distribution, all regular Roth IRA contributions for a year are treated as a single contribution, and all conversion contributions during the year are treated as a single contribution.

*Split-interest trust filing requirements*

Split-interest trusts, including charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, are required to file an annual information return[13] (Form 1041A). Trusts that are not split-interest trusts but that claim a charitable deduction for amounts permanently set aside for a charitable purpose[14] also are required to file Form 1041A. The returns are required to be made publicly available.[15] A trust that is required to distribute all trust net income currently to trust beneficiaries in a taxable year is exempt from this return requirement for such taxable year. A failure to file the required return may result in a penalty on the trust of $10 a day for as long as the failure continues, up to a maximum of $5,000 per return.

In addition, split-interest trusts are required to file annually Form 5227.[16] Form 5227 requires disclosure of information regarding a trust's noncharitable beneficiaries. The penalty for failure to file this return is calculated based on the amount of tax owed. A split-interest trust generally is not subject to tax and therefore, in general, a penalty may not be imposed for the failure to file Form 5227. Form 5227 is not required to be made publicly available.

REASONS FOR CHANGE

Under present law, an individual who wants to use IRA proceeds to make charitable contributions must treat the IRA distribution as a withdrawal subject to IRA income recognition rules and is subject to deduction limitation provisions on the contributions made to the charity.

In some cases, this can result in taxable income even though the individual used the entire IRA distribution to make the charitable contribution. The Committee believes that taxpayers who want to make charitable contributions from IRAs generally should be permitted to do so without recognizing income because of the distribution from the IRA, whether such contribution is made directly to the charitable organization or indirectly through the use of a split-interest entity. The Committee believes that facilitating charitable contributions from IRAs will help increase giving to charitable organizations.

[12] Conversion contributions refer to conversions of amounts in a traditional IRA to a Roth IRA.
[13] Sec. 6034. This requirement applies to all split-interest trusts described in section 4947(a)(2).
[14] Sec. 642(c).
[15] Sec. 6104(b).
[16] Sec. 6011; Treas. Reg. sec. 53.6011–1(d).

EXPLANATION OF PROVISION

*Qualified charitable distributions from IRAs*

The provision provides an exclusion from gross income for otherwise taxable IRA distributions from a traditional or a Roth IRA in the case of qualified charitable distributions. Special rules apply in determining the amount of an IRA distribution that is otherwise taxable. The present-law rules regarding taxation of IRA distributions and the deduction of charitable contributions continue to apply to distributions from an IRA that are not qualified charitable distributions.

A qualified charitable distribution is defined as any distribution from an IRA that is made directly by the IRA trustee either to (1) an organization to which deductible contributions can be made (a "direct distribution") or (2) a "split-interest entity." A split-interest entity means a charitable remainder annuity trust or charitable remainder unitrust (together referred to as a "charitable remainder trust"), a pooled income fund, or a charitable gift annuity. Direct distributions are eligible for the exclusion only if made on or after the date the IRA owner attains age 70½. Distributions to a split interest entity are eligible for the exclusion only if made on or after the date the IRA owner attains age 59½. In the case of split-interest distributions, no person may hold an income interest in the amounts in the split-interest entity attributable to the charitable distribution other than the IRA owner, his or her spouse, or a charitable organization.

The exclusion applies to direct distributions only if a charitable contribution deduction for the entire distribution would otherwise be allowable, determined without regard to the generally applicable percentage limitations. Thus, for example, if the deductible amount is reduced because of a benefit received in exchange, or if a deduction is not allowable because the donor did not obtain sufficient substantiation, the exclusion is not available with respect to any part of the IRA distribution. Similarly, the exclusion applies in the case of a distribution directly to a split-interest entity only if a charitable contribution deduction for the entire present value of the charitable interest (for example, a remainder interest) is allowable, determined without regard to the generally applicable percentage limitations.

If the IRA owner has any IRA that includes nondeductible contributions, a special rule applies in determining the portion of a distribution that is includible in gross income (but for the provision) and thus is eligible for qualified charitable distribution treatment. In such case, the IRA owner aggregates all IRAs to determine eligibility for the exclusion. Under the special rule, the distribution is treated as consisting of income first, up to the aggregate amount that is includible in gross income (but for the provision) if all amounts were distributed from all IRAs otherwise taken into account in determining the amount of IRA distributions during the year that is includible in income. In determining the amount of subsequent IRA distributions includible in income, proper adjustments are made to reflect the amount treated as a qualified charitable distribution under the special rule.

Special rules apply for distributions to split-interest entities. For distributions to charitable remainder trusts, the provision provides that subsequent distributions from the charitable remainder trust are treated as ordinary income in the hands of the beneficiary, notwithstanding how such amounts normally are treated under section 664(b). In addition, for a charitable remainder trust to be eligible to receive qualified charitable distributions, the charitable remainder trust has to be funded exclusively by such distributions. For example, an IRA owner may not make qualified charitable distributions to an existing charitable remainder trust any part of which was funded with assets that were not qualified charitable distributions.

Under the provision, a pooled income fund is eligible to receive qualified charitable distributions only if the fund accounts separately for amounts attributable to such distributions. In addition, all distributions from the pooled income fund that are attributable to qualified charitable distributions are treated as ordinary income to the beneficiary. Qualified charitable distributions to a pooled income fund are not includible in the fund's gross income.

In determining the amount includible in gross income by reason of a payment from a charitable gift annuity purchased with a qualified charitable distribution from an IRA, the portion of the distribution from the IRA used to purchase the annuity is not an investment in the annuity contract.

Any amount excluded from gross income by reason of the provision is not taken into account in determining the deduction for charitable contributions under section 170.

*Qualified charitable distribution examples*

The following examples illustrate the determination of the portion of an IRA distribution that is a qualified charitable distribution and the application of the special rules for a qualified charitable distribution to a split-interest entity. In each example, it is assumed that the requirements for qualified charitable distribution treatment are otherwise met (e.g., the applicable age requirement and the requirement that contributions are otherwise deductible) and that no other IRA distributions occur during the year.

Example 1. Individual A has a traditional IRA with a balance of $100,000, consisting solely of deductible contributions and earnings. Individual A has no other IRA. The entire IRA balance is distributed in a direct distribution to a charitable organization. Under present law, the entire distribution of $100,000 would be includible in Individual A's income. Accordingly, under the provision, the entire distribution of $100,000 is a qualified charitable distribution. As a result, no amount is included in Individual A's income as a result of the distribution and the distribution is not taken into account in determining the amount of Individual A's charitable deduction for the year.

Example 2. The facts are the same as in Example 1, except that the entire IRA balance of $100,000 is distributed to a charitable remainder unitrust, which contains no other assets. Under the terms of the trust, Individual A is entitled to receive five percent of the value of the trust each year. As explained in Example l, the entire $100,000 distribution is a qualified charitable distribution, no amount is included in Individual A's income as a result of the distribution, and the distribution is not taken into account in determining the amount of Individual A's charitable deduction for the year. In addition, under a special rule in the provision for charitable remainder trusts, any distribution from the charitable remainder unitrust to Individual A is includible in gross income as ordinary income, regardless of the character of the distribution under the usual rules for the taxation of distributions from such a trust.

Example 3. Individual B has a traditional IRA with a balance of $100,000, consisting of $20,000 of nondeductible contributions and $80,000 of deductible contributions and earnings. Individual B has no other IRA. In a direct distribution to a charitable organization, $80,000 is distributed from the IRA. Under present law, a portion of the distribution from the IRA would be treated as a nontaxable return of nondeductible contributions. The nontaxable portion of the distribution would be $16,000, determined by multiplying the amount of the distribution ($80,000) by the ratio of the nondeductible contributions to the account balance ($20,000/$100,000). Accordingly, under present law, $64,000 of the distribution ($80,000 minus $16,000) would be includible in Individual B's income.

Under the provision, notwithstanding the present-law tax treatment of IRA distributions, the distribution is treated as consisting of income first, up to the total amount that would be includible in gross income (but for the provision) if all amounts were distributed from all IRAs otherwise taken into account in determining the amount of IRA distributions. The total amount that would be includible in income if all amounts were distributed from the IRA is $80,000. Accordingly, under the provision, the entire $80,000 distributed to the charitable organization is treated as includible in income (before application of the provision) and is a qualified charitable distribution. As a result, no amount is included in Individual B's income as a result of the distribution and the distribution is not taken into account in determining the amount of Individual B's charitable deduction for the year. In addition, for purposes of determining the tax treatment of other distributions from the IRA, $20,000 of the amount remaining in the IRA is treated as Individual B's nondeductible contributions.

*Split-interest trust filing requirements*

The provision increases the penalty on split-interest trusts for failure to file a return and for failure to include any of the information required to be shown on such return and to show the correct information. The penalty is $20 for each day the failure continues up to $10,000 for any one return. In the case of a split-interest trust with gross income in excess of $250,000, the penalty is $100 for each day the failure continues up to a maximum of $50,000. In addition, if a person (meaning any officer, director, trustee, employee, or other individual who is under a duty to file the return or include required information)[17] knowingly failed to file the return or include required information, then that person is personally liable for such a penalty, which would be imposed in addition to the penalty that is paid by the organization. Information regarding beneficiaries that are not charitable organizations as described in section 170(c) is exempt from the requirement to make information publicly available. In addition, the provision repeals the present-

[17] Sec. 6652(c)(4)(C).

law exception to the filing requirement for split-interest trusts that are required in a taxable year to distribute all net income currently to beneficiaries. Such exception remains available to trusts other than split-interest trusts that are otherwise subject to the filing requirement.

#### EFFECTIVE DATE

The provision generally is effective for taxable years beginning after December 31, 2002. The provision relating to information returns of split-interest trusts is effective for returns for taxable years beginning after December 31, 2002.

### C. CHARITABLE DEDUCTION FOR CONTRIBUTIONS OF FOOD INVENTORY

(Sec. 103 of the bill and sec. 170 of the Code)

#### PRESENT LAW

Under present law, a taxpayer's deduction for charitable contributions of inventory generally is limited to the taxpayer's basis (typically, cost) in the inventory.

However, for certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciated value (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis.[18] To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in section 501(c)(3) (except for private nonoperating foundations), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements. In the case of contributed property subject to the Federal Food, Drug, and Cosmetic Act, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer.

To use the enhanced deduction, the taxpayer must establish that the fair market value of the donated item exceeds basis. The valuation of food inventory has been the subject of ongoing disputes between taxpayers and the IRS. In one case, the Tax Court held that the value of surplus bread inventory donated to charity was the full retail price of the bread rather than half the retail price, as the IRS asserted.[19]

#### REASONS FOR CHANGE

The Committee believes that expanding the present-law enhanced deduction for contributions of food inventory to non-C corporations will increase charitable contributions of food to those in need. By clarifying the definition of fair market value, the Committee believes that taxpayers will be better able to avoid disputes with the IRS about the valuation of food and receive an appropriate

[18] Sec. 170(e)(3). In general, a C corporation's charitable contribution deductions for a year may not exceed 10 percent of the corporation's taxable income. Sec. 170(b)(2).

[19] *Lucky Stores Inc.* v. *Commissioner,* 105 T.C. 420 (1995).

deduction for their contribution. In addition, the Committee believes that providing certain low-basis taxpayers with a deemed basis equal to one quarter of the fair market value of the food will increase food donations, thus further providing needed nourishment to the nation's hungry.

EXPLANATION OF PROVISION

Under the provision, any taxpayer, whether or not a C corporation, engaged in a trade or business is eligible to claim the enhanced deduction for donations of food inventory. For taxpayers other than C corporations, the total deduction for donations of food inventory in a taxable year generally may not exceed 10 percent of the taxpayer's net income for such year from its trade or business (or interest therein) from which contributions are made. For example, if a taxpayer is a sole proprietor, a shareholder in an S corporation, and a partner in a partnership, and each business makes charitable contributions of food inventory, the taxpayer's deduction for donations of food inventory is limited to 10 percent of the taxpayer's net income from the sole proprietorship, and the taxpayer's interests in the S corporation and partnership. However, if only the sole proprietorship and the S corporation made charitable contributions of food inventory, the taxpayer's deduction would be limited to 10 percent of the net income from the trade or business of the sole proprietorship and the S corporation, but not the partnership.

The 10 percent limitation does not affect the application of the generally applicable percentage limitations. For example, if 10 percent of a sole proprietor's net income from the proprietor's trade or business was greater than 50 percent of the proprietor's contribution base, the available deduction for the taxable year (with respect to contributions to public charities) would be 50 percent of the proprietor's contribution base. Consistent with present law, such contributions may be carried forward because they exceed the 50 percent limitation. Contributions of food inventory by a taxpayer that is not a C corporation that exceed the 10 percent limitation but not the 50 percent limitation could not be carried forward.

For purposes of calculating the enhanced deduction, taxpayers who do not account for inventories under section 471 and who are not required to capitalize indirect costs under section 263A are able to elect to treat the basis of the contributed food as being equal to 25 percent of the food's fair market value.[20]

Under the provision, the enhanced deduction is available only for food that qualifies as "apparently wholesome food." "Apparently wholesome food" is defined as food intended for human consumption that meets all quality and labeling standards imposed by Federal, State, and local laws and regulations even though the food may not be readily marketable due to appearance, age, freshness, grade, size, surplus, or other conditions.

In addition, the provision provides that the fair market value of donated apparently wholesome food that cannot or will not be sold solely due to internal standards of the taxpayer or lack of market is determined without regard to such internal standards or lack of market and by taking into account the price at which the same or

[20] This includes, for example, taxpayers who are eligible for administrative relief under Revenue Procedures 2002–28 and 2001–10.

substantially the same food items are sold by the taxpayer at the time of the contribution or, if not so sold at such time, in the recent past.

### EFFECTIVE DATE

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

## D. CHARITABLE DEDUCTION FOR CONTRIBUTIONS OF BOOK INVENTORY

(Sec. 104 of the bill and sec. 170 of the Code)

### PRESENT LAW

Under present law, a taxpayer's deduction for charitable contributions of inventory generally is limited to the taxpayer's basis (typically, cost) in the inventory.

However, for certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciated value (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis.[21] To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in section 501(c)(3) (except for private nonoperating foundations), and the donee must: (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements.

### REASONS FOR CHANGE

Under present law, taxpayers sometimes are prohibited from receiving an enhanced deduction for charitable contributions of their book inventory, in part because of the requirement that the inventory be used for care of the ill, the needy, or infants. For example, such requirement generally prohibits donations to public libraries and adult literacy programs. The Committee believes that suitable book inventory should be eligible for an enhanced deduction in cases where a contribution is made to an appropriate educational organization. To minimize disputes between taxpayers and the IRS about the value of books and to encourage contributions of books that are suitable in terms of currency, content, and quantity, the Committee provides a special rule for determining the amount of the contribution of such books. A clear rule is needed so that taxpayers know that if they donate books to schools, libraries, and literacy programs, they will receive an enhanced deduction that more adequately reflects the costs of the donation.

### EXPLANATION OF PROVISION

The provision modifies the present-law enhanced deduction for C corporations so that it is equal to the lesser of fair market value or twice the taxpayer's basis in the case of qualified book contribu-

[21] Sec. 170(e)(3).

tions. The provision provides that the fair market value for this purpose is determined by reference to a bona fide published market price for the book (using the same printing and same edition), published within seven years preceding the contribution. The Committee intends that a bona fide published market price of a book would be a price that was reached as a result of an arm's length transaction within the seven years preceding the contribution, and for which the book was customarily sold. A publisher's listed retail price for a book would not meet the standard unless the publisher could demonstrate to the satisfaction of the Secretary that the price was one at which the book was customarily sold. For example, if a publisher entered into a contract with a local school district to sell textbooks six years prior to making a qualified book contribution of such textbooks, the publisher could use as a "bona fide published market price," the price at which such books were regularly sold to the school district under the contract. By contrast, if a publisher listed in a catalogue or elsewhere a "suggested retail price," but books were not in fact frequently sold at such price, the publisher could not use the "suggested retail price" to determine the fair market value of the book for purposes of the enhanced deduction. Thus, in general, the Committee intends that a bona fide published market price must be independently verifiable by reference to actual sales within the seven year period preceding the contribution, and not to a publisher's own price list.

As an illustration of the mechanics of calculating the enhanced deduction under the provision, a C corporation that made a qualified book contribution with a bona fide published market price of $10 and a basis of $4 could take a deduction of $8 (twice basis). If the taxpayer's basis is $6 instead of $4, then the deduction is $10. Also, in such latter case, if the book's bona fide market published market price was $5 at the time of the contribution but was $10 five years before the contribution, then the deduction is $10.

A qualified book contribution means a charitable contribution of books to: (1) an educational organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on; (2) a public library; or (3) an organization described in section 501(c)(3) (except for private nonoperating foundations), that is organized primarily to make books available to the general public at no cost or to operate a literacy program. The donee must: (1) use the property consistent with the donee's exempt purpose; (2) not transfer the property in exchange for money, other property, or services; (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements and also that the books are suitable, in terms of currency, content, and quantity, for use in the donee's educational programs and that the donee will use the books in such educational programs.

EFFECTIVE DATE

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

## E. Expand Charitable Contribution Allowed for Scientific Property Used for Research and for Computer Technology and Equipment

(Sec. 105 of the bill and sec. 170 of the Code)

### PRESENT LAW

In the case of a charitable contribution of inventory or other ordinary-income or short- term capital gain property, the amount of the charitable deduction generally is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose. In cases involving contributions to a private foundation (other than certain private operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property.[22]

Under present law, a taxpayer's deduction for charitable contributions of scientific property used for research and for contributions of computer technology and equipment generally is limited to the taxpayer's basis (typically, cost) in the property. However, certain corporations may claim a deduction in excess of basis for a "qualified research contribution" or a "qualified computer contribution."[23] This enhanced deduction is equal to the lesser of (1) basis plus one-half of the item's appreciated value (i.e., basis plus one half of fair market value minus basis) or (2) two times basis.

A qualified research contribution means a charitable contribution of inventory that is tangible personal property. The contribution must be to a qualified educational or scientific organization and be made not later than two years after construction of the property is substantially completed. The original use of the property must be by the donee, and be used substantially for research or experimentation, or for research training, in the U.S. in the physical or biological sciences. The property must be scientific equipment or apparatus, constructed by the taxpayer, and may not be transferred by the donee in exchange for money, other property, or services. The donee must provide the taxpayer with a written statement representing that it will use the property in accordance with the conditions for the deduction. For purposes of the enhanced deduction, property is considered constructed by the taxpayer only if the cost of the parts used in the construction of the property (other than parts manufactured by the taxpayer or a related person) do not exceed 50 percent of the taxpayer's basis in the property.

A qualified computer contribution means a charitable contribution of any computer technology or equipment, which meets standards of functionality and suitability as established by the Secretary of the Treasury. The contribution must be to certain educational organizations or public libraries and made not later than three years after the taxpayer acquired the property or, if the taxpayer constructed the property, not later than the date construction of the

[22] Sec. 170(e)(1).

[23] Secs. 170(e)(4) and 170(e)(6).

property is substantially completed.[24] The original use of the property must be by the donor or the donee,[25] and in the case of the donee, must be used substantially for educational purposes related to the function or purpose of the donee. The property must fit productively into the donee's education plan. The donee may not transfer the property in exchange for money, other property, or services, except for shipping, installation, and transfer costs. To determine whether property is constructed by the taxpayer, the rules applicable to qualified research contributions apply. Contributions may be made to private foundations under certain conditions.[26]

REASONS FOR CHANGE

The Committee believes that extension of the enhanced deduction to include property assembled by the taxpayer will lead to increased charitable contributions of scientific property used for research and computer technology and equipment and will help to eliminate confusion in determining whether property is "constructed" or "assembled" for purposes of claiming the enhanced deduction.

EXPLANATION OF PROVISION

Under the provision, property assembled by the taxpayer, in addition to property constructed by the taxpayer, is eligible for either enhanced deduction. The Committee does not intend that old or used components assembled by the taxpayer into scientific property or computer technology or equipment are eligible for the enhanced deduction.

EFFECTIVE DATE

The provision is effective for taxable years beginning after December 31, 2001.

## F. Encourage Contributions of Capital Gain Real Property Made for Conservation Purposes

(Sec. 106 of the bill and sec. 170 of the Code)

PRESENT LAW

*Charitable contributions generally*

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization. The amount of deduction generally equals the fair market value of the contributed property on the date of the contribution. Charitable deductions are provided for income, estate, and gift tax purposes.[27]

In general, in any taxable year, charitable contributions by a corporation are not deductible to the extent the aggregate contributions exceed 10 percent of the corporation's taxable income com-

[24] If the taxpayer constructed the property and reacquired such property, the contribution must be within three years of the date the original construction was substantially completed. Sec. 170(e)(6)(D)(i).

[25] This requirement does not apply if the property was reacquired by the manufacturer and contributed. Sec. 170(e)(6)(D)(ii).

[26] Sec. 170(e)(6)(C).

[27] Secs. 170, 2055, and 2522, respectively.

puted without regard to net operating or capital loss carrybacks. For individuals, the amount deductible is a percentage of the taxpayer's contribution base, which is the taxpayer's adjusted gross income computed without regard to any net operating loss carryback. The applicable percentage of the contribution base varies depending on the type of donee organization and property contributed. Cash contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer's contribution base. Cash contributions to private foundations and certain other charitable organizations generally may be deducted up to 30 percent of the taxpayer's contribution base.

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity while also either retaining an interest in that property or transferring an interest in that property to a noncharity for less than full and adequate consideration. Exceptions to this general rule are provided for, among other interests, remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property, and qualified conservation contributions.

*Capital gain property*

Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property to a qualified charity are deductible at fair market value within certain limitations. Contributions of capital gain property to charitable organizations described in section 170(b)(1)(A) (e.g., public charities, private foundations other than private non-operating foundations, and certain governmental units) generally are deductible up to 30 percent of the taxpayer's contribution base. An individual may elect, however, to bring all these contributions of capital gain property for a taxable year within the 50-percent limitation category by reducing the amount of the contribution deduction by the amount of the appreciation in the capital gain property. Contributions of capital gain property to charitable organizations described in section 170(b)(1)(B) (e.g., private non-operating foundations) are deductible up to 20 percent of the taxpayer's contribution base.

For purposes of determining whether a taxpayer's aggregate charitable contributions in a taxable year exceed the applicable percentage limitation, contributions of capital gain property are taken into account after other charitable contributions. Contributions of capital gain property that exceed the percentage limitation may be carried forward for five years.

*Qualified conservation contributions*

Qualified conservation contributions are not subject to the "partial interest" rule, which generally bars deductions for charitable contributions of partial interests in property. A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made of the real property. Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations. Conservation purposes include: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy; and (4) the preservation of an historically important land area or a certified historic structure.

Qualified conservation contributions of capital gain property are subject to the same limitations and carryover rules of other charitable contributions of capital gain property.

REASONS FOR CHANGE

The Committee desires to provide additional incentives for charitable donations of real property made for qualified conservation purposes. The Committee believes that increasing the percentage limitations applicable to qualified conservation contributions of real property, and increasing the carryover period applicable to such contributions from five to fifteen years, will increase donations made for qualified conservation purposes. The Committee also believes that special incentives are required to encourage qualified conservation contributions of farm and ranch properties.

EXPLANATION OF PROVISION

*In general*

Under the provision, the 30-percent contribution base limitation on contributions of capital gain property by individuals does not apply to qualified conservation contributions (as defined under present law). Thus, individuals may include the fair market value of any qualified conservation contribution of capital gain property in determining the amount of the charitable contributions subject to the 50-percent contribution base limitation.

Individuals are allowed to carryover any qualified conservation contributions that exceed the 50-percent limitation for up to 15 years. The 50-percent contribution base limitation applies first to contributions other than qualified conservation contributions and then to qualified conservation contributions. For example, assume an individual with a contribution base of $100 makes a qualified conservation contribution of property with a fair market value of $80 and makes other charitable contributions of $60. The individual is allowed a deduction of $50 in the current taxable year for the other contributions (50 percent of the $100 contribution base) and is allowed to carryover the excess $10 for up to 5 years. No current deduction is allowed for the qualified conservation contribution but the entire $80 qualified conservation contribution may be carried forward for up to 15 years.

*Farmers and ranchers*

In the case of an eligible farmer or rancher, a qualified conservation contribution is allowable up to 100 percent of the taxpayer's contribution base (after taking into account other charitable contributions). This rule applies both to individuals and corporations. In addition, corporate (as well as non-corporate) eligible farmers and ranchers are allowed to carryover any excess qualified conservation contributions for up to 15 years. The 100-percent contribution base limitation applies first to contributions other than qualified conservation contributions (to the extent allowable under other percentage limitations) and then to qualified conservation contributions. For example, assume an individual farmer or rancher with a contribution base of $100 makes a qualified conservation contribution of property with a fair market value of $80 and makes other charitable contributions of $60. The individual is allowed a deduction of $50 in the current taxable year for the other contributions (50 percent of the $100 contribution base) and is allowed to carryover the excess $10 for up to 5 years. The individual is also allowed a deduction of $50 in the current taxable year for the qualified charitable contribution (the amount of the remaining contribution base). The remaining $30 qualified conservation contribution may be carried forward for up to 15 years.

For this purpose, an eligible farmer or rancher means a taxpayer (other than a publicly traded C corporation) whose gross income from the trade of business of farming is at least 51 percent of the taxpayer's gross income for the taxable year.

EFFECTIVE DATE

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

## G. Exclusion of 25 Percent of Capital Gain for Certain Sales Made for Qualifying Conservation Purposes

(Sec. 107 of the bill and new sec. 121A of the Code)

PRESENT LAW

*Sales of capital gain property*

Gain from the sale or exchange of land held more than one year generally is treated as long-term capital gain. Generally, the net capital gain of an individual (i.e., long-term capital gain less short-term capital loss) is subject to a maximum tax rate of 20 percent.

*Charitable contributions of capital gain property for conservation purposes*

Special rules apply to charitable contributions of qualified conservation contributions. Qualified conservation contributions are not subject to the "partial interest" rule, which generally bars deductions for charitable contributions of partial interests in property. A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made of the real property. Charitable contributions of interests that constitute the taxpayer's entire interest in the property are not regarded as qualified real property interests within the meaning of section 170(h),[28] but instead are subject to the general rules applicable to charitable contributions of entire interests of the taxpayer. Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations. Conservation purposes include: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy; and (4) the preservation of an historically important land area or a certified historic structure.

Treasury regulations provide that a deduction for a qualified conservation contribution is allowed only if the donor prohibits in the instrument of conveyance the donee from subsequently transferring the qualified real property interest, whether or not for consideration, unless the donee organization, as a condition of the subsequent transfer, requires that the conservation purpose which the contribution was originally intended to advance continues to be carried out.[29] Moreover, subsequent transfers of such interests are restricted to organizations that are qualified conservation organizations.[30]

REASONS FOR CHANGE

Some landowners may want their land to be protected for conservation purposes but cannot afford simply to donate either the land or an easement on the land, especially if the land is the landowner's primary asset. The Committee desires to encourage the sale of appreciated, environmentally sensitive land and real property interests in land or water, as well as controlling stock interests in certain land corporations, to qualified conservation organizations and governments, thus achieving conservation goals through voluntary sales of property. The Committee believes that providing taxpayers a partial exclusion of capital gain derived from the voluntary sale of properties for conservation purposes will increase the number of properties dedicated to conservation purposes. The Committee desires to facilitate the transfers of properties to conservation organizations in a manner that will, to the extent practicable, preserve the value of the properties once they are acquired by the conservation organizations, while providing safeguards designed to ensure the protection of the conservation purposes for which the properties are intended to be used.

[28] Ltr. Rul. 8626029.
[29] Treas. Reg. sec. 1.170A–14(c)(2).
[30] Id.

EXPLANATION OF PROVISION

*In general*

The bill provides a 25–percent exclusion from gross income of long-term capital gain from the qualifying sale or exchange of land, or an interest in land or water rights, provided that the land or interest in land or water rights constitutes an interest in real property that has been held by the taxpayer or the taxpayer's family at all times during the five years preceding the date of sale. The qualifying sale must be made to a qualified organization that intends that the acquired property be used for qualified conservation purposes in perpetuity.[31]

*Qualifying interests*

The exclusion applies only to sales or exchanges of real property interests in land or water rights that constitute the entire interest of the taxpayer in such land or water rights, or that constitute qualified real property interests as defined in section 170(h), specifically: (1) the entire interest of the taxpayer other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use which may be made of the real property. Partial interests in property that are not the entire interest of the taxpayer or a qualified real property interest do not qualify for the exclusion. For example, a taxpayer who owns land and related mineral rights but who sells only the mineral rights is not eligible for the exclusion. However, a taxpayer who owns only mineral rights is eligible for the 25–percent exclusion if the taxpayer sells his or her entire interest in the mineral rights and satisfies the other requirements of the provision.

Generally, an undivided interest that constitutes the taxpayer's entire interest in the property is eligible for the exclusion. A partial interest (for example, an undivided interest) that constitutes the taxpayer's entire interest in the property, however, does not qualify for the exclusion if the property in which such partial interest exists was divided in an attempt to avoid the partial interest rules. The Committee intends that the partial interest rules contained in Treasury Regulations section 1.170A–7(a)(2)(i) and generally applicable to contributions of partial interests be applied similarly for purposes of this provision. For example, if a taxpayer transfers an undivided interest in property to a spouse and immediately thereafter sells the remaining undivided interest to a qualified organization, the exclusion will not apply to the taxpayer's sale to the qualified organization.

Under the provision, the exclusion is available for long-term capital gain from certain sales or exchanges of stock in a C corporation if the qualified organization ultimately obtains a controlling stock interest (generally a stock interest that provides the qualified organization at least 90 percent of the total voting power and total value of the corporation's stock) and if at least 90 percent of the fair market value of the C corporation's assets at the time of the

[31] The exclusion is mandatory if all of the requirements of the provision are satisfied, and a taxpayer need not file an election to take advantage of the exclusion. A taxpayer who transfers qualifying property to a qualified organization may opt out of the 25-percent exclusion by choosing not to satisfy one or more of the provision's requirements without having to file a formal election with the Secretary, such as by failing to obtain the requisite letter of intent from the qualified organization.

sale or exchange consists of land or water rights, or interests in land or water rights, that were held by the corporation at all times during the five years preceding the sale. Stock in a corporation will not qualify if at the time of the sale or exchange the fair market value of water rights and infrastructure relating to the delivery of water constitutes more than 50 percent of the fair market value of all of the corporation's assets. Only a stock interest held by the taxpayer or the taxpayer's family at all times during the five years preceding the sale qualifies for the 25–percent exclusion. The Committee intends that in appropriate circumstances a controlling stock interest may be acquired by the qualified organization from multiple persons in multiple transactions, and authorizes the Secretary to issue guidance regarding the availability of the exclusion in such cases.

*Qualifying gain*

The exclusion applies only to long-term capital gain. Gain treated as ordinary income, such as under depreciation recapture provisions, is not eligible for the exclusion. Gain attributable to certain improvements, such as buildings or structures that do not further a qualified conservation purpose ("disqualified improvements"), also does not qualify for the exclusion.[32] The bill provides that the maximum amount of gain that may be excluded by a shareholder in the case of a sale or exchange of a controlling stock interest is 25 percent of the shareholder's proportionate share of the C corporation's underlying gain attributable to qualifying land, water rights, or interests therein held by the C corporation.

Consistent with present law, the determination of gain or loss is to be calculated on an asset-by-asset basis whenever that is required for other purposes of the Code (such as for purposes of section 1245 or section 1250). To minimize administrative complexity and assist taxpayers in the preparation of their returns, the Committee intends that in those cases where the Code does not otherwise require a separate determination of gain or loss for the disqualified improvement, the gain allocable to the disqualified improvement shall be determined by reference to the fair market value of the disqualified improvement relative to the fair market value of all assets for which a gain or loss determination is not otherwise required by the Code.[33]

For example, if a taxpayer sells a qualifying land interest with a fair market value of $100 and a basis of $30, that includes a building or structure that does not further a conservation purpose (a disqualified improvement) and that has a fair market value of $40, the taxpayer must determine the portion of the gain that is attributable to the eligible land and to the disqualified improvement. If determination of gain or loss on the sale of the improvement is required for other purposes of the Code, then the gain or loss determined for those purposes governs, and the taxpayer must determine his or her basis of the disqualified improvement (in this

[32] The Committee intends that soil and water conservation expenditures in the nature of those described in section 175, determined without regard to whether the taxpayer is engaged in a farming business and that the land be used for farming, generally be treated as furthering a qualified conservation purpose.

[33] The Committee intends that the taxpayer be required to use this gain allocation rule unless the taxpayer has adequate records to substantiate the adjusted basis and fair market value to support a separate calculation.

case, assumed to be zero), with the result that the $40 gain on the disqualified improvement is not eligible for the 25–percent exclusion and the gain of $30 on the land is eligible for the 25–percent exclusion. On the other hand, if the determination of gain or loss on the sale of the improvement is not required for other purposes of the Code, then the Committee intends that the taxpayer allocate the aggregate gain of $70 attributable to the land and the disqualified improvement between the land and the improvement on the basis of their respective fair market values (i.e., 40 percent to the improvement and 60 percent to the land). Under this gain allocation rule, the $28 of gain allocable to the improvement is not eligible for the 25–percent exclusion, and the $42 of gain allocable to the land qualifies for the 25-percent exclusion.

*Eligible sales*

An eligible sale is a sale or exchange (excluding a transfer made by order of condemnation or eminent domain)[34] that may be made only to a qualified organization, defined as a Federal, State, or local government, or an agency or department thereof or a section 501(c)(3) organization that is organized and operated primarily to meet a qualified conservation purpose. In addition, to be an eligible sale, the organization acquiring the property interest must provide the taxpayer with a letter stating that the intent of such organization in acquiring the property is to further a qualified conservation purpose and that any subsequent transfer of the acquired interest will be to a qualified organization and made to protect the conservation purpose in perpetuity. A qualified conservation purpose is: (1) the preservation of land areas for outdoor recreation by, or the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; or (3) the preservation of open space (including farmland and forest land) where the preservation is for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy and will yield a significant public benefit.

*Protection of conservation purposes*

The bill provides for the imposition of penalty excise taxes in appropriate cases where a qualified organization fails to take steps consistent with the protection of conservation purposes. Because the penalty taxes are imposed on an organization that fails to protect the conservation purpose, and do not serve to encumber the property in the same manner as a restriction contained in an instrument of conveyance, the Committee believes that the penalty taxes will adequately protect conservation purposes without decreasing the value of the property in the hands of the conservation organizations.

If ownership or possession of the property is transferred by a qualified organization other than to another qualified organization, or a legal restriction contained in an instrument of conveyance that protects the qualified conservation purpose is removed, then: (1) a 20-percent excise tax applies to the proceeds or fair market value

[34] A sale or exchange made prior to the issuance of an order, but that is the result of the threat of condemnation or eminent domain, may qualify for the exclusion.

of the property, (2) any realized gain or income is subject to an additional excise tax imposed at the highest income tax rate applicable to C corporations, and (3) any otherwise applicable non-recognition provisions of the Code shall not apply to the transferor. The Committee intends that the excise taxes apply to all cases involving the transfer of ownership or possession of the property to a transferee that is not a qualified organization unless the transferring qualified organization demonstrates to the satisfaction of the Secretary that qualified conservation purposes will be protected in perpetuity. In the case of a removal of a legal restriction contained in an instrument of conveyance, the qualified organization must demonstrate to the satisfaction of the Secretary that a later unexpected change in the conditions surrounding the property makes retaining the conservation restriction impossible or impractical and that any proceeds derived from the removal of the restriction will be used to further qualified conservation purposes. The Committee authorizes the Secretary to provide guidance to identify appropriate cases where transfers to persons other than qualified organizations are regarded as protecting a conservation purpose in perpetuity. The Committee intends, for example, that a qualified organization may acquire a fee simple interest in real property operated as a farm and then transfer, without imposition of the penalty taxes, the real property subject to a conservation easement that constitutes a qualified real property interest if, in a recorded instrument of conveyance, the transferor prohibits the transferee from subsequently transferring the real property unless the transferee, as a condition of the subsequent transfer, requires that the qualified conservation purpose of preserving the property as open space farmland will continue to be carried out.

In the case of a transfer by a qualified organization to another qualified organization, the transferee must provide the transferor at the time of the transfer a letter stating that the intent of the transferee is to further a qualified conservation purpose and that any subsequent transfer of the acquired interest will be made to protect the conservation purpose in perpetuity, and the transferee becomes subject to the excise tax provisions for subsequent transfers. The Committee intends that in the case of a sale or exchange of stock of a C corporation in which a qualified organization acquires a controlling stock interest, all of the stock of such corporation acquired by the qualified organization (including any stock which did not qualify for the exclusion), as well as the property held by such C corporation, becomes subject to the penalty tax provisions.

The bill provides that the Secretary may require such reporting as may be necessary or appropriate to further the purpose that any conservation use be in perpetuity.

*Relationship with other provisions*

In the case of an individual, the exclusion applies both for purposes of the regular tax and the alternative minimum tax. In the case of a corporation, the present-law alternative minimum tax provisions apply without modification.

If a taxpayer sells a real property interest to a qualified organization for less than the property's fair market value, the amount of any charitable contribution deduction is determined in accordance with the bargain sale rules,[35] and the taxpayer shall not fail to qualify for a contribution deduction under those rules solely because the taxpayer derives a tax benefit from the partial exclusion of long-term capital gain from the sale. For example, if a taxpayer sells qualifying land with a fair market value of $100 and an adjusted basis of $10 to a qualified organization for a sales price of $95 (or alternatively, for a sale price of $50), the taxpayer's basis of $10 shall be allocated between the sale and the contribution components of the transfer under the bargain sale rules, and the tax savings resulting from the 25-percent exclusion of long-term capital gain on the sale will not reduce the portion of the transfer treated as a charitable contribution under the bargain sale rules. The present-law requirements applicable to the charitable contribution component of the transfer, including, for example, the recordkeeping, substantiation, and appraisal provisions of Treasury Regulations section 1.170A–13, must be satisfied.

#### EFFECTIVE DATE

The provision is effective for sales or exchanges occurring after December 31, 2003, in taxable years ending after such date.

### H. COST SHARING PAYMENTS UNDER THE PARTNERS FOR FISH AND WILDLIFE PROGRAM

(Sec. 108 of the bill and sec. 126 of the Code)

#### PRESENT LAW

Under present law, gross income does not include the excludable portion of payments made to taxpayers by federal and state governments for a share of the cost of improvements to property under certain conservation programs. These programs include payments received under (1) the rural clean water program authorized by section 208(j) of the Federal Water Pollution Control Act, (2) the rural abandoned mine program authorized by section 406 of the Surface Mining Control and Reclamation Act of 1977, (3) the water bank program authorized by the Water Bank Act, (4) the emergency conservation measures program authorized by title IV of the Agricultural Credit Act of 1978, (5) the agriculture conservation program authorized by the Soil Conservation and Domestic Allotment Act, (6) the great plains conservation program authorized by section 16 of the Soil Conservation and Domestic Policy Act, (7) the resource conservation and development program authorized by the Bankhead-Jones Farm Tenant Act and by the Soil Conservation and Domestic Allotment Act, (8) the forestry incentives program authorized by section 4 of the Cooperative Forestry Assistance Act of 1978, (9) any small watershed program administered by the Secretary of Agriculture which is determined by the Secretary of the Treasury or his delegate to be substantially similar to the type of programs described in items (1) through (8), and (10) any program of a State, possession of the United States, a political subdivision of any of the foregoing, or the District of Columbia under which payments are made to individuals primarily for the purpose of con-

[35] Sec. 1011(b) and Treas. Reg. sec. 1.1011–2.

serving soil, protecting or restoring the environment, improving forests, or providing a habitat for wildlife.

REASONS FOR CHANGE

The Committee believes that payments received by taxpayers under the Partners for Fish and Wildlife Program are similar to payments made under other government programs that are excludable from gross income under present law. Accordingly, the Committee believes it is appropriate to extend the present-law exclusion to payments under this program.

EXPLANATION OF PROVISION

The provision expands the types of qualified cost-sharing payments to include payments under the Partners for Fish and Wildlife Program.

EFFECTIVE DATE

The provision applies to taxable years beginning after December 31, 2002.

## I. Basis Adjustment to Stock of S Corporation Contributing Property

(Sec. 109 of the bill and sec. 1367 of the Code)

PRESENT LAW

Under present law, if an S corporation contributes money or other property to a charity, each shareholder takes into account the shareholder's pro rata share of the contribution in determining its own income tax liability.[36] A shareholder of an S corporation reduces the basis in the stock of the S corporation by the amount of the charitable contribution that flows through to the shareholder.[37]

REASONS FOR CHANGE

Under present law, if an S corporation makes a charitable contribution of appreciated property, the shareholder may be taxed on an amount equal to the appreciation in the contributed property when the S corporation stock is sold. Thus, under present law, a charitable contribution of appreciated property made by an S corporation receives less favorable tax treatment than other contributions of appreciated property.

The Committee wishes to preserve the benefit of providing a charitable contribution deduction for contributions of property by an S corporation with a fair market value in excess of its adjusted basis. Thus, the bill provides that the basis adjustment to the stock of an S corporation for charitable contributions made by the corporation will be in an amount equal to the shareholder's pro rata share of the adjusted basis of the property contributed. This adjustment will prevent the later recognition of gain attributable to the appreciation in the contributed property on the disposition of the S corporation stock.

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[36] Sec. 1366(a)(1)(A).
[37] Sec. 1367(a)(2)(B).

### EXPLANATION OF PROVISION

The provision provides that the amount of a shareholder's basis reduction in the stock of an S corporation by reason of a charitable contribution made by the corporation will be equal to the shareholder's pro rata share of the adjusted basis of the contributed property.[38]

Thus, for example, assume an S corporation with one individual shareholder makes a charitable contribution of stock with a basis of $200 and a fair market value of $500. The shareholder will be treated as having made a $500 charitable contribution (or a lesser amount if the special rules of section 170(e) apply), and will reduce the basis of the S corporation stock by $200.

### EFFECTIVE DATE

The provision applies to contributions made in taxable years beginning after December 31, 2002.

## J. ENHANCED DEDUCTION FOR CHARITABLE CONTRIBUTION OF LITERARY, MUSICAL, ARTISTIC, AND SCHOLARLY COMPOSITIONS

(Sec. 110 of the bill and sec. 170 of the Code)

### PRESENT LAW

In the case of a charitable contribution of inventory or other ordinary-income or short- term capital gain property, the amount of the deduction generally is limited to the taxpayer's basis in the property.[39] In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose. In cases involving contributions of tangible personal property to a private foundation (other than certain private foundations),[40] the amount of the deduction is limited to the taxpayer's basis in the property.

Under present law, charitable contributions of literary, musical, and artistic compositions are considered ordinary income property and a taxpayer's deduction of such property is limited to the taxpayer's basis (typically, cost) in the property. To be eligible for the deduction, the contribution must be of an undivided portion of the donor's entire interest in the property.[41] For purposes of the charitable income tax deduction, the copyright and the work in which the copyright is embodied are not treated as separate property interests. Accordingly, if a donor owns a work of art and the copyright to the work of art, a gift of the artwork without the copyright or the copyright without the artwork will constitute a gift of a "partial interest" and will not qualify for the income tax charitable deduction.

### REASONS FOR CHANGE

The Committee believes that it is appropriate to provide an enhanced deduction for charitable contributions of certain literary,

[38] See Rev. Rul. 96–11 (1996–1 C.B. 140) for a rule reaching a similar result in the case of charitable contributions madee by a partnership.
[39] Sec. 170(e)(1).
[40] Sec. 170(e)(1)(B)(ii).
[41] Sec. 170(f)(3).

musical, artistic, and scholarly compositions created by the personal efforts of the donor. In many cases, such works have a low basis, and because present law generally limits the deduction for such contributions to basis, the creators of literary, musical, artistic, and scholarly compositions do not have an appropriate incentive to contribute their works to charity. In addition, the Committee believes that the present-law rule that a charitable contribution deduction generally is not available for contributions of less than the taxpayer's entire property interest is an inappropriate disincentive for contributions of such works.

EXPLANATION OF PROVISION

The bill provides that a deduction for "qualified artistic charitable contributions" generally is increased from the value under present law (generally, basis) to the fair market value of the property contributed, measured at the time of the contribution. However, the amount of the increase of the deduction provided by the provision may not exceed the amount of the donor's adjusted gross income for the taxable year attributable to: (1) income from the sale or use of property created by the personal efforts of the donor that is of the same type as the donated property; and (2) income from teaching, lecturing, performing, or similar activities with respect to such property. In addition, the increase to the present-law deduction provided by the provision may not be carried over and deducted in other taxable years.

The provision defines a qualified artistic charitable contribution to mean a charitable contribution of any literary, musical, artistic, or scholarly composition, or similar property, or the copyright thereon (or both) that meets certain requirements. First, the contributed property must have been created by the personal efforts of the donor at least 18 months prior to the date of contribution. The Committee intends that "personal efforts" shall be defined by reference to Treasury regulations section 1.1221–1(c). Second, the donor must obtain a qualified appraisal of the contributed property, a copy of which is required to be attached to the donor's income tax return for the taxable year in which such contribution is made. The appraisal must include evidence of the extent (if any) to which property created by the personal efforts of the taxpayer and of the same type as the donated property is or has been owned, maintained, and displayed by certain charitable organizations and sold to or exchanged by persons other than the taxpayer, donee, or any related person. Third, the contribution must be made to a public charity or to certain limited types of private foundations. Finally, the use of donated property by the recipient organization must be related to the organization's charitable purpose or function, and the donor must receive a written statement from the organization verifying such use.

Under the provision, the tangible property and the copyright on such property are treated as separate properties for purposes of the "partial interest" rule; thus, a gift of artwork without the copyright or a copyright without the artwork does not constitute a gift of a partial interest and is deductible. Contributions of letters, memoranda, or similar property that are written, prepared, or produced by or for an individual while the individual is an officer or employee of any person (including a government agency or instrumentality) do not qualify for a fair market value deduction unless the contributed property is entirely personal.

EFFECTIVE DATE

The deduction for qualified artistic charitable contributions applies to contributions made after December 31, 2002, in taxable years ending after such date.

## Title II. Disclosure of Information Relating to Tax-Exempt Organizations

### A. Disclosure of Written Determinations

(Sec. 201 of the bill and sec. 6110 of the Code)

PRESENT LAW

*In general*

Three provisions of present law govern the disclosure of information relating to tax-exempt organizations. First, section 6103 provides a general rule that tax returns and return information generally are not subject to public disclosure.[42] Second, in order to allow the public to scrutinize the activities of tax-exempt organizations, section 6104 grants an exception to the confidentiality rule of section 6103 for certain categories of tax-exempt organization documents and information. Section 6104 permits the release in unredacted form of approved applications for tax-exempt status, certain related documents, and annual information returns filed by tax-exempt organizations. As a general rule, to the extent section 6104 specifically provides for the disclosure of tax-exempt organization information, other disclosure provisions do not apply. If tax-exempt organization information does not come within the scope of section 6104, other disclosure provisions will govern whether the information may be disclosed. Third, section 6110 provides that written determinations by the IRS and related background file documents generally are open to public inspection in redacted form. Section 6110 does not apply to any matter to which section 6104 applies.[43]

*Disclosure of applications for recognition of tax exemption and annual information returns*

Under present law, tax-exempt organizations are required to make a copy of their application for recognition of tax-exempt status (and certain related documents)[44] and their annual information

[42] Sec. 6103(a). A "return" includes any tax or information return, declaration of estimated tax, or claim for refund required by, or provided for, or permitted under the provisions of the Code, which is filed with the IRS. Sec. 6103(b)(1). "Return" also includes any amendment or supplement to the filed return. Sec. 6103(b)(1). "Return information" is defined broadly to include any data received by, recorded by, prepared by, furnished to, or collected by the Secretary with respect to a return or with respect to the determination of the existence, or possible existence, of liability (or the amount thereof) of any person for any tax, penalty, interest, fine, forfeiture, or other imposition, or offense under the Code. The term "return information" does not include data in a form that cannot be associated with, or otherwise identify, directly or indirectly, a particular taxpayer. Sec. 6103(b)(2).

[43] Sec. 6110(l)(1).

[44] Section 6104(a)(1)(A) provides that "any papers submitted in support of" an application for tax-exempt status must be available for inspection. Treasury regulations limit the definition of

Continued

return (Form 990 or Form 990–PF) available for public inspection. Organizations are not required to disclose an application for tax exemption filed by the organization unless the IRS responded favorably to the application.[45] Charitable organizations that are not classified as private foundations are not required to disclose the names of donors to the organization.

The Secretary may withhold disclosure of certain information described in an organization's application for tax-exempt status if disclosure would: (1) divulge a trade secret, patent, process, style of work, or apparatus of the organization, and the Secretary determines that such disclosure would harm the organization; or (2) that the Secretary determines would harm the national defense.[46] The organization must apply to the Commissioner for a determination that the disclosure would violate one of these criteria. The organization will be given 15 days to contest an adverse determination before the information is made available for public inspection.[47]

*Disclosure of written determinations*

Section 6110 provides that the text of any written determination by the IRS and related background file document is open to public inspection.[48] The term "written determination" means a ruling,[49] determination letter,[50] technical advice memorandum,[51] or Chief Counsel advice.[52] Closing agreements, which are final and conclusive written agreements entered into by the IRS and a taxpayer in order to settle the taxpayer's tax liability with respect to a taxable year, do not constitute written determinations.[53] A background file document includes the request for a written determination, any written material submitted by the taxpayer in support of the request, and any communications between the IRS and other persons in connection with the written determination received before issuance of the written determination.[54]

A background file document is available upon written request to any person requesting a copy of the related written determina-

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supporting documents to papers submitted by the organization. Treas. Reg. sec. 301.6104(a)–1(e).

[45] Treas. Reg. sec. 301.6104(d)–1(b)(3)(iii)(A).

[46] Sec. 6104(a)(1)(D). In the case of a pension plan, information may be withheld if it would identify any particular individual covered under the plan. *Id.*

[47] Treas. Reg. sec. 301.6104(a)–5(a)(1).

[48] Sec. 6110(a).

[49] A ruling is a written statement issued by the National Office to a taxpayer or his or her authorized representative. Treas. Reg. sec. 301.6110–2(d). It generally recites the relevant facts, sets forth the applicable provisions of law, and shows the application of the law to the facts. Treas. Reg. sec. 301.6110–2(d).

[50] A district director issues a "determination letter" in response to a written inquiry from an individual or organization that applies principles and precedents previously announced by the IRS National Office to the particular facts involved. Treas. Reg. sec. 301.6110–2(e).

[51] A "technical advice memorandum" is a written statement issued by the IRS National Office to a district director in connection with the examination of a taxpayer's return or consideration of a taxpayer's claim for refund or credit. Treas. Reg. sec. 301.6110–2(f). Generally, a technical advice memorandum states the relevant facts, sets forth the applicable law, and states a legal conclusion. Treas. Reg. sec. 301.6110–2(f).

[52] Sec. 6110(b)(1). Any IRS National Office component of the Office of Chief Counsel can issue Chief Counsel advice. The IRS National Office component issues the advice to IRS field or service center employees, or to regional or district employees of Chief Counsel. Sec. 6110(i)(A)(i). The definition of Chief Counsel advice does not encompass advice issued from one IRS National Office component of the Office of Chief Counsel to another. The advice by definition conveys: (1) a legal interpretation of a revenue provision; (2) the IRS or Chief Counsel position or policy concerning a revenue provision; or (3) a legal interpretation of any law (Federal, State, or foreign) relating to the assessment or collection of liability under a revenue provision. Sec. 6110(i)(A)(ii).

[53] Sec. 6103(b)(2)(D); sec. 6110(b)(1)(B).

[54] Sec. 6110(b)(2). Communications between the IRS and the Department of Justice relating to a pending civil or criminal case are not considered background file documents.

tion.[55] Before releasing any written determination or background file document, the IRS must delete identifying details of the person about whom the written determination pertains and certain other information.[56] With respect to tax-exempt organizations, disclosure under section 6110 is limited to letters and rulings unrelated to an organization's tax-exempt status.[57]

The application of section 6110 to guidance relating to tax-exempt organizations is limited. Section 6110(l)(1) provides, "this section shall not apply to any matter to which section 6104 applies." The regulations under section 6110 clarify which matters are within the ambit of section 6104 and, therefore, are not subject to disclosure under section 6110:

> [a]ny application filed with the Internal Revenue Service with respect to the qualification or exempt status of an organization * * *; any document issued by the Internal Revenue Service in which the qualification or exempt status of an organization is * * * granted, denied or revoked or the portion of any document in which technical advice with respect thereto is given to a district director; * * * the portion of any document issued by the Internal Revenue Service in which is discussed the effect on the qualification or exempt status of an organization * * * of proposed transactions by such organization * * * ; and any document issued by the Internal Revenue Service in which is discussed the qualification or status of a [private foundation or private operating foundation].[58]

In addition, the regulations under section 6104 provide that some determination letters and other documents relating to tax exemption that are not open to public inspection under section 6104(a)(1)(A) are nevertheless "within the ambit" of section 6104 for purposes of the disclosure provisions of section 6110.[59] The regulation explains that the following documents are, therefore, not available for public inspection under either section 6104 or 6110:

(1) Unfavorable rulings or determination letters issued in response to applications for tax exemption;

(2) Rulings or determination letters revoking or modifying a favorable determination letter;

(3) Technical advice memoranda relating to a disapproved application for tax exemption or the revocation or modification of a favorable determination letter;

[55] Sec. 6110(e).

[56] Sec. 6110(c) provides the following exemptions from disclosure: (1) the names, addresses, and other identifying details of the person to whom the written determination pertains and of any other person, other than a person with respect to whom a notation is made under subsection (d)(1) (relating to third party contacts), identified in the written determination or any background file document; (2) information specifically authorized under criteria established by an Executive order to be kept secret in the interest of national defense or foreign policy, and which is in fact properly classified pursuant to such Executive order; (3) information specifically exempted from disclosure by any statute (other than this title) which is applicable to the Internal Revenue Service; (4) trade secrets and commercial or financial information obtained from a person and privileged or confidential; (5) information the disclosure of which would constitute a clearly unwarranted invasion of personal privacy; (6) information contained in or related to examination, operating, or condition reports prepared by, or on behalf of, or for use of an agency responsible for the regulation or supervision of financial institutions; and (7) geological and geophysical information and data, including maps, concerning wells.

[57] Sec. 6110(l)(1); Treas. Reg. sec. 301.6110–1(a).

[58] Treas. Reg. sec. 301.6110–1(a).

[58] Treas. Reg. sec. 301.6104(a)–1(i).

(4) Any letter or document filed with or issued by the IRS relating to whether a proposed or accomplished transaction is a prohibited transaction under section 503;

(5) Any letter or document filed with or issued by the IRS relating to an organization's status as a private foundation or private operating foundation, unless the letter or document relates to the organization's application for tax exemption; and

(6) Any other letter or document filed with or issued by the IRS which, although it relates to an organization's tax exempt status as an organization described in section 501(c), does not relate to that organization's application for tax exemption.[60]

The effect of these limitations is that written determinations relating to exempt status issues are not released, even in redacted form. The IRS does, however, release written determinations issued to tax-exempt organizations that include issues that clearly are not within the ambit of section 6104, such as the application of the unrelated business income tax to a particular proposed transaction.

## REASONS FOR CHANGE

The Committee believes that present law inappropriately protects from disclosure certain written determinations and background file documents that relate to the tax-exempt status of organizations described in section 501(c) and (d). The Committee believes that written determinations and background file documents that ordinarily would be disclosed under section 6110 but for the nondisclosure provided by section 6104 should be disclosed in redacted form, and that such disclosure will provide additional guidance to taxpayers as to the views of the IRS on certain issues.

## EXPLANATION OF PROVISION

The provision requires disclosure in redacted form of written determinations and related background file documents, as defined in section 6110, relating to the tax-exempt status of an organization described in section 501(c) or (d) that are not required to be disclosed by section 6104(a)(1)(A) but that are within the scope of section 6104 and thus are not presently disclosed. The provision provides that such written determinations and related background file documents shall be disclosed under the provisions of section 6110. Documents that are within the scope of section 6104 and that are not presently disclosed include: (1) unfavorable rulings or determination letters issued in response to applications for tax exemption; (2) rulings or determination letters revoking or modifying a favorable determination letter; (3) technical advice memoranda relating to a disapproved application for tax exemption or the revocation or modification of a favorable determination letter; (4) any letter or document filed with or issued by the IRS relating to whether a proposed or accomplished transaction is a prohibited transaction under section 503; (5) any letter or document filed with or issued by the IRS relating to an organization's status as a private foundation or private operating foundation, unless the letter or document relates to the organization's application for tax exemption; and (6) any other letter or document filed with or issued by the IRS which, although it relates to an organization's tax exempt status as an or-

[60] Id.

ganization described in section 501(c) or (d), does not relate to that organization's application for tax exemption. To the extent section 6110 applies to such documents, they would be disclosed under the provision.

#### EFFECTIVE DATE

The provision is effective for written determinations issued after December 31, 2002.

### B. DISCLOSURE OF INTERNET WEB SITE AND NAME UNDER WHICH ORGANIZATION DOES BUSINESS

(Sec. 202 of the bill and sec. 6033 of the Code)

#### PRESENT LAW

Most types of tax-exempt organizations are required to file annually an information return.[61] The Internal Revenue Code does not require an exempt organization to furnish on the applicable information return any name under which the organization operates or does business, if such name differs from the legal name of the organization, or the organization's Internet web site address, if any.[62]

#### REASONS FOR CHANGE

Some tax-exempt organizations do business and solicit contributions under a name that is different from the organization's legal name. This can cause confusion to individuals and others seeking information about the organization. Further, although much information regarding the operations and activities of tax-exempt organizations is available on the Internet web sites of such organizations, some members of the public might experience difficulties obtaining access to an organization's web site if they do not know the organization's web site address. The Committee believes that reducing confusion and increasing public access to relevant information regarding a tax-exempt organization would be achieved by requiring a tax-exempt organization to report on its annual return any name under which such organization operates or does business, and the Internet web site address (if any) of such organization.[63]

#### EXPLANATION OF PROVISION

The provision requires a tax-exempt organization subject to reporting requirements under section 6033(a) to include on its annual return any name under which such organization operates or does business, and the Internet web site address (if any) of such organization.

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[61] Sec. 6033(a). See, e.g., Form 990—Return of Organization Exempt From Income Tax. An organization that is required to file Form 990, but that has gross receipts of less than $100,000 during its taxable year, and total assets of less than $250,000 at the end of its taxable year, may file Form 990–EZ instead of Form 990. Private foundations are required to file Form 990–PF rather than Form 990.

[62] The IRS requires disclosure of an organization's Internet web site address on Forms 990 and 990–EZ.

[63] The staff of the Joint Committee on Taxation recommended the adoption of this provision. Joint Committee on Taxation, Study of Present-Law Taxpayer Confidentiality and Disclosure Provisions as Required by Section 3802 of the Internal Revenue Service Restructuring and Reform Act of 1998, Volume II: Study of Disclosure Provisions Relating to Tax-Exempt Organizations (JCS–1–00), January 28, 2000 at 96–97.

EFFECTIVE DATE

The provision applies to returns filed after December 31, 2002.

### C. Modification to Reporting of Capital Transactions

(Sec. 203 of the bill and secs. 6033 and 6104 of the Code)

PRESENT LAW

Private foundations are required to file an annual information return (Form 990–PF).[64] Part IV of the Form 990–PF requires that private foundations report detailed information regarding the gain or loss from the sale or other disposition of property, including a description of the property sold, how it was acquired (purchase or donation), the date acquired, the date sold, the gross sales price, the amount of depreciation allowed or allowable, and the cost or other basis plus expenses of the sale. Such information generally is required for the IRS to calculate the tax on the private foundation's net investment income. The Form 990–PF is required to be made available to the public.

REASONS FOR CHANGE

Under present law, private foundations that engage in capital transactions must report detailed information about each transaction on Form 990–PF, which is filed with the IRS and available to the public. For some foundations, listing these transactions involves hundreds of pages. The Committee believes that automatic disclosure of such voluminous information does not necessarily benefit the public, and may in fact reduce the level of meaningful disclosure by obscuring other important information. The Committee believes that meaningful disclosure to the public will be increased if the version of the Form 990–PF that is automatically available to the public summarizes rather than lists the capital transactions that affect the calculation of the organization's net investment income. In order to preserve the public's access to more specific information regarding such capital transactions, the Committee believes that the more detailed information provided to the IRS on the Form 990–PF should be made available to those members of the public that explicitly request such information.[65]

EXPLANATION OF PROVISION

The provision requires that any information regarding capital gains and losses that is required to be furnished by private foundations in order to calculate the tax on net investment income be furnished also in summary form.

In addition, information regarding capital gains and losses required to be filed with the IRS but that is not in summary form is not required to be made available to the public by the IRS or by the private foundation except by the explicit request of a member of the public to the IRS or to the foundation. A member of the

[64] Sec. 6033(a).

[65] The staff of the Joint Committee on Taxation recommended the adoption of this provision. Joint Committee on Taxation, Study of Present-Law Taxpayer Confidentiality and Disclosure Provisions as Required by Section 3802 of the Internal Revenue Service Restructuring and Reform Act of 1998, Volume II: Study of Disclosure Provisions Relating to Tax-Exempt Organizations (JCS–1–00), January 28, 2000 at 99.

public may request disclosure of such information from the Secretary, who shall prescribe the manner of making such request and the manner of disclosure. A member of the public also may request disclosure of the private foundation, which must be made in person or in writing. If the request is made in person, the foundation shall provide a copy of the information immediately and, if the request is made in writing, the foundation shall provide the information within 30 days.

The bill also provides that private foundations are required to state on the furnished summary that the more detailed description is available upon request.

EFFECTIVE DATE

The provision applies to returns filed after December 31, 2002.

### D. Disclosure That Form 990 Is Publicly Available

(Sec. 204 of the bill)

PRESENT LAW

Under present law, there is no requirement that the IRS notify the public that the Form 990 is publicly available.

REASONS FOR CHANGE

The information provided on Forms 990 is useful to the public only to the extent that the public is aware that the form are publicly available. The Committee believes that the availability of Forms 990 that have been filed by exempt organizations will be increased by requiring the IRS to inform the public regarding the availability of such forms.

EXPLANATION OF PROVISION

The provision requires the IRS to notify the public in appropriate publications and other materials of the extent to which an exempt organization's Form 990, Form 990–EZ, and Form 990–PF are publicly available.[66]

EFFECTIVE DATE

The provision applies to publications or materials issued or revised after the date of enactment.

### E. Disclosure to State Officials of Proposed Actions Related to Section 501(c) Organizations

(Sec. 205 of the bill and sec. 6104 of the Code)

PRESENT LAW

In the case of organizations that are described in section 501(c)(3) and exempt from tax under section 501(a) or that have applied for exemption as an organization so described, present law

[66] The staff of the Joint Committee on Taxation recommended the adoption of this provision. Joint Committee on Taxation, Study of Present-Law Taxpayer Confidentiality and Disclosure Provisions as Required by Section 3802 of the Internal Revenue Service Restructuring and Reform Act of 1998, Volume II: Study of Disclosure Provisions Relating to Tax-Exempt Organizations (JCS–1–00), January 28, 2000 at 96–97.

(sec. 6104(c)) requires that Secretary to notify the appropriate State officer of (1) a refusal to recognize such organization as an organization described in section 501(c)(3, (2) a revocation of a section 501(c)(3) organization's tax-exempt status, and (3) the mailing of a notice of deficiency for an tax imposed under section 507, chapter 41, or chapter 42.[67] In addition, at the request of such appropriate State officer, the Secretary is required to make available for inspection and copying, such returns, filed statements, records, reports, and other information relating to the above-described disclosures, as are relevant to any State law determination. An appropriate State officer is the State attorney general, State tax officer, or any State official charged with overseeing organizations of the type described in section 501(c)(3).

In general, return and return information (as such terms are defined in sec. 6103(b)) is confidential and may not be disclosed or inspected unless expressly provided by law.[68] Present law requires the Secretary to keep records of disclosures and requests for inspection[69] and requires that persons authorized to receive return and return information maintain various safeguards to protect such information against unauthorized disclosure.[70] Willful unauthorized disclosure or inspection of return or return information is subject to a fine and/or imprisonment.[71] The knowing or negligent unauthorized inspection or disclosure of returns or return information gives the taxpayer a right to bring a civil suit.[72] Such present-law protections against unauthorized disclosure or inspection of return and return information do not apply to the disclosures or inspections, described above, that are authorized by section 6104(c).

REASONS FOR CHANGE

The Committee believes that State officials that are charged with oversight of certain organizations described in section 501(c) have an important and legitimate interest in receiving certain information about such organizations' tax-exempt status and tax filings, in some cases before the IRS has made a final determination with respect to an organization's tax-exempt status or liability for tax. By providing appropriate State officials with earlier access to information about the activities of certain section 501(c) organizations, State officials will be able to monitor such organizations more effectively and better protect the public's interest in assuring that organizations that have been given the benefit of tax-exemption operate consistently with their exempt purposes. In addition, the Committee believes that permitting the IRS to share return and return information about certain section 501(c) organizations with appropriate State officials, when doing so will facilitate the resolution of

[67] The applicable taxes include the termination tax on private foundations; taxes on public charities for certain excess lobbying expenses; taxes on a private foundation's net investment income, self-dealing activities, undistributed income, excess business holdings, investments that jeopardize charitable purposes, and taxable expenditures (some of these taxes also apply to certain non-exempt trusts); taxes on the political expenditures and excess benefit transactions of section 501(c)(3) organizations; and certain taxes on black lung benefit trusts and foreign organizations.

[68] Sec. 6103(a).

[69] Sec. 6103(p)(3).

[70] Sec. 6103(p)(4).

[71] Secs. 7213 and 7213A.

[72] Sec. 7431.

Federal or State issues relating to the organization's tax-exempt status, will significantly improve oversight of such organizations.

The Committee stresses the importance of maintaining the confidentiality of taxpayer return and return information and believes it is important to extend existing protections against unauthorized disclosure or inspection of return and return information to disclosures made or inspections allowed by the Secretary of return and return information regarding such section 501(c) organizations.

EXPLANATION OF PROVISION

The bill provides that upon written request by an appropriate State officer, the Secretary may disclose: (1) a notice of proposed refusal to recognize an organization as a section 501(c)(3) organization; (2) a notice of proposed revocation of tax-exemption of a section 501(c)(3) organization; (3) the issuance of a proposed deficiency of tax imposed under section 507, chapter 41, or chapter 42; (4) the names and taxpayer identification numbers of organizations that have applied for recognition as section 501(c)(3) organizations; and (5) return and return information of organizations[73] with respect to which information has been disclosed under (1) through (4) above. Disclosure or inspection is permitted for the purpose of, and only to the extent necessary in, the administration of State laws regulating section 501(c)(3) organizations, such as laws regulating tax-exempt status, charitable trusts, charitable solicitation, and fraud. Disclosure or inspection may be made only to or by designated representatives of the appropriate State officer, which does not include independent contractors. The Secretary also is permitted to disclose or open to inspection the return and return information of an organization that is recognized as tax- exempt under section 501(c)(3), or that has applied for such recognition, to an appropriate State officer if the Secretary determines that disclosure or inspection may facilitate the resolution of Federal or State issues relating to the tax-exempt status of the organization. For this purpose, appropriate State officer means the State attorney general or any other State official charged with overseeing organizations of the type described in section 501(c)(3).

In addition, the bill provides that upon the written request by an appropriate State officer, the Secretary may make available for inspection or disclosure returns and return information of an organization described in section 501(c)(2) (certain title holding companies), 501(c)(4) (certain social welfare organizations), 501(c)(6) (certain business leagues and similar organizations), 501(c)(7) (certain recreational clubs), 501(c)(8) (certain fraternal organizations), 501(c)(10) (certain domestic fraternal organizations operating under the lodge system), and 501(c)(13) (certain cemetery companies). Such return and return information is available for inspection or disclosure only for the purpose of, and to the extent necessary in, the administration of State laws regulating the tax-exempt status of such organizations. Disclosure or inspection may be made only to or by designated representatives of the appropriate State officer, which does not include independent contractors. For this purpose, appropriate State officer means the State attorney general and the head of an agency designated by the State attorney general as hav-

[73] Such information also may be open to inspection by an appropriate State officer.

ing primary responsibility for overseeing the tax-exempt status of such organizations.

In addition, the bill provides that any return and return information disclosed under section 6104(c) may be disclosed in civil administrative and judicial proceedings pertaining to the enforcement of State laws regulating the applicable tax-exempt organization in a manner prescribed by the Secretary. Returns and return information are not to be disclosed under section 6104(c), or in such an administrative or judicial proceeding, to the extent that the Secretary determines that such disclosure would seriously impair Federal tax administration. The provision makes disclosures of returns and return information under section 6104(c) subject to many of the provisions of section 6103, including the requirements that such information remain confidential (sec. 6103(a)(2)), that the Secretary maintain a permanent system of records of requests for disclosure (sec. 6103(p)(3)), and that the appropriate State officer maintain various safeguards that protect against unauthorized disclosure (sec. 6103(p)(4)). The bill provides that the willful unauthorized disclosure of return or return information described in section 6104(c) is a felony subject to a fine of up to $5,000 and/or imprisonment of up to five years (sec. 7213(a)(2)), the willful unauthorized inspection of return or return information described in section 6104(c) is subject to a fine of up to $1,000 and/or imprisonment of up to one year (sec. 7213A), and provides the taxpayer the right to bring a civil action for damages in the case of knowing or negligent unauthorized disclosure or inspection of such information (sec. 7431(a)(2)).

#### EFFECTIVE DATE

The provision is effective on the date of enactment but does not apply to requests made before such date.

## Title III. Other Charitable and Exempt Organization Provisions

### A. MODIFY TAX ON UNRELATED BUSINESS TAXABLE INCOME OF CHARITABLE REMAINDER TRUSTS

(Sec. 301 of the bill and sec. 664 of the Code)

#### PRESENT LAW

Charitable remainder annuity trusts and charitable remainder unitrusts are exempt from Federal income tax for a tax year unless the trust has any unrelated business taxable income for the year. Unrelated business taxable income includes certain debt financed income. A charitable remainder trust that loses exemption from income tax for a taxable year is taxed as a regular complex trust. As such, the trust is allowed a deduction in computing taxable income for amounts required to be distributed in a taxable year, not to exceed the amount of the trust's distributable net income for the year. Taxes imposed on the trust are required to be allocated to corpus.[74]

Distributions from a charitable remainder annuity trust or charitable remainder unitrust are treated in the following order as: (1) ordinary income to the extent of the trust's current and previously

[74] Treas. Reg. sec. 1.664–1(d)(2).

undistributed ordinary income for the trust's year in which the distribution occurred, (2) capital gains to the extent of the trust's current capital gain and previously undistributed capital gain for the trust's year in which the distribution occurred, (3) other income (e.g., tax-exempt income) to the extent of the trust's current and previously undistributed other income for the trust's year in which the distribution occurred, and (4) corpus.[75]

In general, distributions to the extent they are characterized as income are includible in the income of the beneficiary for the year that the annuity or unitrust amount is required to be distributed even though the annuity or unitrust amount is not distributed until after the close of the trust's taxable year.[76]

A charitable remainder annuity trust is a trust that is required to pay, at least annually, a fixed dollar amount of at least five percent of the initial value of the trust to a noncharity for the life of an individual or for a period of 20 years or less, with the remainder passing to charity. A charitable remainder unitrust is a trust that generally is required to pay, at least annually, a fixed percentage of at least five percent of the fair market value of the trust's assets determined at least annually to a noncharity for the life of an individual or for a period 20 years or less, with the remainder passing to charity.[77]

A trust does not qualify as a charitable remainder annuity trust if the annuity for a year is greater than 50 percent of the initial fair market value of the trust's assets. A trust does not qualify as a charitable remainder unitrust if the percentage of assets that are required to be distributed at least annually is greater than 50 percent. A trust does not qualify as a charitable remainder annuity trust or a charitable remainder unitrust unless the value of the remainder interest in the trust is at least 10 percent of the value of the assets contributed to the trust.

### Reasons for Change

The Committee believes that in years that a charitable remainder trust has unrelated business income, an excise tax of 100 percent on such income is a more appropriate remedy than loss of tax exemption for the year.

### EXPLANATION OF PROVISION

The provision imposes a 100–percent excise tax on the unrelated business taxable income of a charitable remainder trust. This replaces the present-law rule that takes away the income tax exemption of a charitable remainder trust for any year in which the trust has any unrelated business taxable income. Consistent with present law, the tax is treated as paid from corpus. The unrelated business taxable income is considered income of the trust for purposes of determining the character of the distribution made to the beneficiary.

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[75] Sec. 664(b).
[76] Treas. Reg. sec. 1.664–1(d)(4).
[77] Sec. 664(d).

### EFFECTIVE DATE

The provision is effective for taxable years beginning after December 31, 2001.

## B. MODIFY TAX TREATMENT OF CERTAIN PAYMENTS TO CONTROLLING EXEMPT ORGANIZATIONS

(Sec. 302 of the bill and sec. 512 of the Code)

### PRESENT LAW

In general, interest, rents, royalties, and annuities are excluded from the unrelated business income of tax-exempt organizations. However, section 512(b)(13) generally treats otherwise excluded rent, royalty, annuity, and interest income as unrelated business income if such income is received from a taxable or tax-exempt subsidiary that is 50 percent controlled by the parent tax-exempt organization. In the case of a stock subsidiary, "control" means ownership by vote or value of more than 50 percent of the stock. In the case of a partnership or other entity, control means ownership of more than 50 percent of the profits, capital or beneficial interests. In addition, present law applies the constructive ownership rules of section 318 for purposes of section 512(b)(13). Thus, a parent exempt organization is deemed to control any subsidiary in which it holds more than 50 percent of the voting power or value, directly (as in the case of a first-tier subsidiary) or indirectly (as in the case of a second-tier subsidiary).

Under present law, interest, rent, annuity, or royalty payments made by a controlled entity to a tax-exempt organization are includable in the latter organization's unrelated business income and are subject to the unrelated business income tax to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity.

The Taxpayer Relief Act of 1997 (the "1997 Act") made several modifications to the control requirement of section 512(b)(13). In order to provide transitional relief, the changes made by the 1997 Act do not apply to any payment received or accrued during the first two taxable years beginning on or after the date of enactment of the 1997 Act (August 5, 1997) if such payment is received or accrued pursuant to a binding written contract in effect on June 8, 1997, and at all times thereafter before such payment (but not pursuant to any contract provision that permits optional accelerated payments).

### REASONS FOR CHANGE

The present-law rule that requires a controlling entity to include as unrelated business income certain payments made by a controlled entity applies without regard to whether the amount of the payment is fair and reasonable under the circumstances or would otherwise constitute unrelated business income if paid by an organization not controlled by the exempt organization. The Committee believes that the controlling organization should not be subject to the unrelated business income tax if the amount of the payment from the controlled entity is determined in accordance with established arm's-length principles. The Committee intends that the controlling organization be subject to the present-law rule only to the extent that a payment made by a controlled entity exceeds the amount that would have been paid if the payment had been determined under established arm's-length principles. In order to discourage controlled entities from claiming deductions in excess of the arm's-length amount, the Committee believes that it is appropriate to subject the controlling organization to a penalty tax for making excess payments.

### EXPLANATION OF PROVISION

The bill provides that the general rule of section 512(b)(13), which includes interest, rent, annuity, or royalty payments made by a controlled entity to a tax-exempt organization in the latter organization's unrelated business income to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity, applies only to the portion of payments received or accrued in a taxable year that exceed the amount of the specified payment that would have been paid or accrued if such payment had been determined under the principles of section 482. Thus, if a payment of rent by a controlled subsidiary to its tax-exempt parent organization exceeds fair market value, the excess amount of such payment over fair market value (as determined in accordance with section 482) is included in the parent organization's unrelated business income, to the extent that such excess reduced the net unrelated income (or increased any net unrelated loss) of the controlled entity. In addition, the provision imposes a 20–percent penalty on the larger of such excess determined without regard to any amendment or supplement to a return of tax, or such excess determined with regard to all such amendments and supplements.

The bill provides that if modifications to section 512(b)(13) made by the 1997 Act did not apply to a contract because of the transitional relief provided by the 1997 Act, then such modifications also do not apply to amounts received or accrued under such contract before January 1, 2001.

### EFFECTIVE DATE

The provision applies to payments received or accrued after December 31, 2000.

## C. SIMPLIFICATION OF LOBBYING EXPENDITURE LIMITATION

(Sec. 303 of the bill and secs. 501 and 4911 of the Code)

### PRESENT LAW

*In general*

An organization does not qualify for tax-exempt status under section 501(c)(3) unless "no substantial part" of the activities of the organization is "carrying on propaganda, or otherwise attempting, to influence legislation," except as provided by section 501(h).[78] Carrying on propaganda and attempting to influence legislation commonly are referred to as "lobbying" activities. Thus, section

[78] Sec. 501(c)(3).

501(c)(3) permits a limited amount of lobbying activity without loss of tax-exempt status.

For purposes of determining whether lobbying activities are a substantial part of an organization's overall functions, an organization may choose between two standards, the "no substantial part" test of section 501(c)(3) or the "expenditure" test of section 501(h).

Whether an organization meets the "no substantial part" test is based on all the facts and circumstances. There is no statutory or regulatory guidance, and it is not clear whether the determination is based on the organization's activities, its expenditures, or both. Alternatively, under section 501(h), certain organizations described in section 501(c)(3) can elect to be subject to the expenditure test,[79] which consists of bright-line rules that specify the dollar amount of permitted expenses on lobbying activities.

*Consequences of excess lobbying under section 501(h)*

Organizations that make a section 501(h) election ("electing charities") are subject to tax if the electing charity makes either "lobbying expenditures" or "grass roots expenditures" in excess of a certain amount established for each type of expenditure for each taxable year. Lobbying expenditures are the sum of grass-roots expenditures and "direct lobbying" expenditures.[80]

The expenditure limits are based on a "lobbying nontaxable amount" for the taxable year and a "grass roots nontaxable amount" for the taxable year. The lobbying nontaxable amount is the lesser of $1 million or an amount determined as a percentage of an organization's exempt purpose expenditures.[81] The grass-roots nontaxable amount is 25 percent of the organization's lobbying nontaxable amount. An electing charity that exceeds either of the spending limitations is subject to a 25 percent tax on the excess. An electing charity that exceeds both of the spending limitations is subject to a 25 percent tax on the greater of the excess of the lobbying expenditures or the grass-roots expenditures.

An electing charity that normally exceeds either of two "ceiling amounts," which are based on the expenditure limits, will lose its tax exemption.[82] The "lobbying ceiling amount" is 150 percent of the electing charity's lobbying nontaxable amount for the taxable year and the "grass roots ceiling amount" is 150 percent of the grass-roots nontaxable amount for the taxable year. For this purpose, "normal" expenditures are calculated based on a four-year averaging mechanism.[83]

*Definitions*

Grass-roots expenditures are defined as "any attempt to influence any legislation through an attempt to affect the opinions of the general public or any segment thereof."[84] For a communication

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[79] Organizations that do not make a section 501(h) election are subject to the "no substantial part" test.

[80] Secs. 501(h)(2)(A), 4911(c)(1), 4911(d).

[81] Exempt purpose expenditures generaally are expenses incurred for exempt purposes, such as amounts paid to accomplish exempt purposes, administrative expenses such as overhead, lobbying expenses, and certain fundraising expenses. Exempt purpose expenditures do not include, for example, expenses not for exempt purposes, payments of unrelated business income tax, or capital expenses in connection with an unrelated business. See Treas. Reg. sec. 56.4911–4.

[82] Sec. 501(h)(1).

[83] Treas. Reg. sec. 1.501(h)–3.

[84] Secs. 501(h)(2)(C) & 4911(d)(1)(A).

to constitute grass-roots lobbying, it must refer to "specific legislation," reflect a view on such legislation, and encourage the recipient of the communication to take action with respect to such legislation (a "call to action").[85] A communication includes a call to action if it incorporates one of four elements: (1) it urges the recipient to contact a legislator, employee of a government body, or any other government official or employee who may participate in the formulation of legislation with the principal purpose of influencing legislation; (2) it states the address, telephone number, or similar information of a legislator or an employee of a legislative body; (3) it provides a petition, tear-off postcard, or similar device for the recipient to communicate with government officials or employees who participate in the formulation of legislation with the principal purpose of influencing legislation; or (4) it states the position of one or more legislators on the legislation, except that a communication may name the main sponsors of legislation for purposes of identifying the legislation without constituting a call to action.[86] In addition, a communication is presumed to be grass-roots lobbying if the communication is a paid advertisement that: (1) appears in the mass media within two weeks before a vote by a legislative body or committee (but not a subcommittee) on a highly publicized piece of legislation; (2) reflects a view on the general subject of the legislation; and (3) either refers to the legislation or encourages the public to communicate with legislators on the general subject of such legislation.[87] The presumption is rebuttable if the electing charity demonstrates that the timing of the communication was not related to the legislation or that the advertisement was of a type regularly made by the electing charity without regard to the timing of the legislation (a customary course of business exception).[88]

Direct lobbying expenditures are "any attempt to influence any legislation through communication with any member or employee of a legislative body, or with any government official or employee who may participate in the formulation of the legislation" if the principal purpose of the communication is to influence legislation.[89] A communication would constitute direct lobbying only if the communication "refers to specific legislation" and reflects a view on such legislation.

Certain specified activities do not constitute attempts to influence legislation and therefore expenditures for such activities are not subject to the expenditure limits for lobbying expenditures or grass-roots expenditures. In general, such activities include: (1) making available the results of nonpartisan analysis, study, or research; (2) providing technical advice or assistance to a governmental body or to a committee in response to a written request; (3) appearances before, or communications to, any legislative body with respect to a possible decision of such body that might affect

[85] Treas. Reg. sec. 56.4911–2(b)(2)(i).

[86] Treas. Reg. sec. 56.4911–2(b)(2)(iii). The regulations provide that the first three elements constitute "direct" encouragement, whereas the fourth element is "indirect" encouragement. This distinction becomes relevant in determining whether a communication meets one of the prescribed exceptions to lobbying, i.e., an indirect call to action in a grass-roots communication may qualify as "nonpartisan analysis, study or research" (Treas. Reg. sec. 56.4911–2(b)(2)(iv)), and in determining the proper allocation of expenses between grass-roots and direct lobbying. Treas. Reg. sec. 56.4911–5(e).

[87] Treas. Reg. sec. 56.4911–2(b)(5)(ii).

[88] *Id.*

[89] Secs. 501(h)(2)(A) and 4911(d)(1)(B) and Treas. Reg. sec. 56.4911–2(b)(1).

the existence of the organization, its powers and duties, tax-exempt status, or the deduction of contributions to the organization (so-called "self-defense" expenditures); (4) certain communications to members of the electing charity; and (5) communications with governmental officials or employees that are not intended to influence legislation.[90]

*Special rules for mixed lobbying expenditures*

Expenses that serve both direct and grass-roots lobbying purposes, e.g., communications that are sent to members and nonmembers, or "mixed lobbying" expenditures, are subject to special rules. The regulations specify how an electing charity is to allocate mixed lobbying expenditures between direct and grass-roots lobbying purposes.[91] For example, for a mixed lobbying communication that is designed primarily for members (i.e., more than half the recipients are members) and that directly encourages grass-roots lobbying (even if it also encourages direct lobbying), the grass-roots expenditure amount includes all the costs of preparing the material used for purposes of grass-roots lobbying plus the mechanical and distributional costs associated with the communication. If a mixed lobbying communication encourages direct lobbying, but only indirectly encourages grass-roots lobbying, then the entire costs of the communication are allocated based on the proportion of members and nonmembers receiving the communication.

*Disclosure of lobbying expenditures*

An electing charity must disclose lobbying expenditures annually on Schedule A of Form 990. In order to meet disclosure requirements, electing charities are required to keep detailed records of direct and grass-roots lobbying expenditures. Required records of grass-roots expenditures include: (1) all amounts directly paid or incurred for grass-roots lobbying; (2) payments to other organizations earmarked for grass-roots lobbying; (3) fees and expenses paid for grass-roots lobbying; (4) the printing, mailing, and other costs of reproducing and distributing materials used in grass-roots lobbying; (5) the portion of amounts paid or incurred as current or deferred compensation for an employee's grass-roots lobbying services; (6) any amount paid for out-of-pocket expenditures incurred on behalf of the electing charity for grass-roots lobbying; (7) the allocable portion of administrative, overhead and other general expenditures attributable to grass-roots lobbying; and (8) expenditures for grass-roots lobbying of a controlled organization.[92]

REASONS FOR CHANGE

The Committee believes that the separate limitation on grass-roots lobbying expenditures is an unnecessary complication for electing charities. The Committee believes that the overall limit on lobbying expenditures is a sufficient ceiling on the lobbying activities of electing charities, irrespective of the proportion of lobbying activities that are grass-roots lobbying or direct lobbying.

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[90] Sec. 4911(d)(2).
[91] Treas. Reg. sec. 56.4911–59(e).
[92] *See* Treas. Reg. sec. 56.4911–6.

### EXPLANATION OF PROVISION

The provision eliminates the separate limitation for grass-roots lobbying expenditures applicable to electing charities. Electing charities remain subject to the overall limitation on lobbying expenditures, which does not change in amount, but electing charities are not required to limit grass roots expenditures as a percentage of overall lobbying. Thus, an electing charity is able to make tax-free any combination of grass-roots and direct lobbying expenditures up to the lobbying non-taxable amount and does not risk loss of tax-exemption as a result of such expenditures until total lobbying expenditures normally exceed the lobbying ceiling amount. For purposes of the section 501(h) election, electing charities are not required to distinguish between grass-roots lobbying and direct lobbying, whether for mixed lobbying expenditures or otherwise.

### EFFECTIVE DATE

The provision is effective for taxable years beginning after December 31, 2001.

## D. EXPEDITED REVIEW PROCESS FOR CERTAIN TAX-EXEMPTION APPLICATIONS

(Sec. 304 of the bill)

### PRESENT LAW

Most organizations that seek tax-exempt status as a charitable organization are required to file an Application for Recognition of Exemption (Form 1023) with the IRS.[93] Organizations that are not required to file Form 1023 include churches, their integrated auxiliaries, and conventions or associations of churches, and any organization (other than a private foundation) that normally has gross receipts of $5,000 or less in a taxable year. Organizations that file Form 1023 within 15 months of the end of the month of the organization's formation will, if the application is approved, be recognized as tax-exempt from the date of formation. The IRS will automatically grant an organization's request for an additional 12–month extension of the 15-month period. Otherwise, exemption normally will be recognized as of the date the application was received by the IRS. In appropriate circumstances, upon written request, the IRS will expedite consideration of applications for tax-exemption. For example, organizations formed to provide relief to victims of disasters or other emergencies often receive expedited consideration.

### REASONS FOR CHANGE

Many social service organizations that want to apply for government funding through grants or contracts are required as a condition of application to have been recognized as an exempt charitable organization. The Committee wishes to facilitate the formation of charitable organizations that intend to work with Federal, State and local governments to provide vital social services to many of the neediest members of society by implementing an expedited review procedure for exempt status applications, and by waiving IRS

[93] Sec. 508(a).

user fees pertaining to such applications filed by smaller social service organizations.

EXPLANATION OF PROVISION

The bill provides that the Secretary or its delegate shall adopt procedures to expedite consideration of applications for exempt status by organizations that are organized and operated for the primary purpose of providing social services. To be eligible, the organization must: (1) be seeking a contract or grant under a Federal, State, or local program that provides funding for social service programs; (2) establish that tax-exempt status is a condition of applying for such contract or grant; (3) include a completed copy of the contract or grant application with the application for exemption; and (4) meet such other criteria as the Secretary may provide. Organizations that meet the eligibility requirements described above (except for the requirement that tax-exempt status is a condition of the contract or grant application), and that certify that the organization's average annual gross receipts over the four year period preceding the application was not more than $50,000 (or, in the case of an organization in existence less than four years, is not expected to be more than $50,000 during the organization's first four years) are entitled to a waiver of any fee for application of tax-exempt status.

For this purpose, social services is defined as services directed at helping people in need, reducing poverty, improving outcomes of low-income children, revitalizing low-income communities, and empowering low-income families and low-income individuals to become self-sufficient, including: (1) child care services, protective services for children and adults, services for children and adults in foster care, adoption services, services related to the management and maintenance of the home, day care services for adults, and services to meet the special needs of children, older individuals, and individuals with disabilities (including physical, mental, or emotional disabilities); (2) transportation services; (3) job training and related services, and employment services; (4) information, referral, and counseling services; (5) the preparation and delivery of meals, and services related to soup kitchens or food banks; (6) health support services; (7) literacy and mentoring programs; (8) services for the prevention and treatment of juvenile delinquency and substance abuse, services for the prevention of crime and the provision of assistance to the victims and the families of criminal offenders, and services related to the intervention in, and prevention of, domestic violence; and (9) services related to the provision of assistance for housing under Federal law. Social services does not include a program having the purpose of delivering educational assistance under the Elementary and Secondary Education Act of 1965 or under the Higher Education Act of 1965.

EFFECTIVE DATE

The provision applies to applications for tax-exempt status filed after December 31, 2002.

## E. Clarification of Definition of Church Tax Inquiry

(Sec. 305 of the bill and sec. 7611 of the Code)

### PRESENT LAW

Under present law, the IRS may begin a church tax inquiry only if an appropriate high-level Treasury official reasonably believes, on the basis of the facts and circumstances recorded in writing, that an organization (1) may not qualify for tax exemption as a church, (2) may be carrying on an unrelated trade or business, or (3) otherwise may be engaged in taxable activities.[94] A church tax inquiry is defined as any inquiry to a church (other than an examination) that serves as a basis for determining whether the organization qualified for tax exemption as a church or whether it is carrying on an unrelated trade or business or otherwise is engaged in taxable activities. An inquiry is considered to commence when the IRS requests information or materials from a church of a type contained in church records, other than routine requests for information or inquiries regarding matters that do not primarily concern the tax status or liability of the church itself.

### REASONS FOR CHANGE

The Committee believes that the present-law church tax inquiry procedures provide important safeguards against the IRS engaging in unnecessary and intrusive examinations of churches. However, the church tax inquiry procedures also have the effect of hampering IRS efforts to educate churches with respect to actions that are not permissible under section 501(c)(3). The Committee believes that a clarification of the scope of the church tax inquiry procedures to make it clear that the IRS may undertake educational outreach efforts with respect to specific churches (e.g., initiating meetings with representatives of a particular church to discuss the rules that apply to such church) will improve compliance with the law by churches.

### EXPLANATION OF PROVISION

The provision clarifies that the church tax inquiry procedures do not apply to contacts made by the IRS for the purpose of educating churches with respect to the federal income tax law governing tax-exempt organizations. For example, the IRS does not violate the church tax inquiry procedures when written materials are provided to a church or churches for the purpose of educating such church or churches with respect to the types of activities that are not permissible under section 501(c)(3).

### EFFECTIVE DATE

The provision is effective on the date of enactment.

[94] Sec. 7611. Prior to the year 2000 IRS restructuring, the lowest level official who could initiate a church tax inquiry was an IRS Regional Commissioner.

## F. Extension of Declaratory Judgment Procedures to Non-501(c)(3) Tax-Exempt Organizations (sec. 306 of the bill and sec. 7428 of the Code)

### PRESENT LAW

In order for an organization to be granted tax exemption as a charitable entity described in section 501(c)(3), it generally must file an application for recognition of exemption with the IRS and receive a favorable determination of its status. Similarly, for most organizations, a charitable organization's eligibility to receive tax-deductible contributions is dependent upon its receipt of a favorable determination from the IRS. In general, a section 501(c)(3) organization can rely on a determination letter or ruling from the IRS regarding its tax-exempt status, unless there is a material change in its character, purposes, or methods of operation. In cases in which an organization violates one or more of the requirements for tax exemption under section 501(c)(3), the IRS is authorized to revoke an organization's tax exemption, notwithstanding an earlier favorable determination.

In situations in which the IRS denies an organization's application for recognition of exemption under section 501(c)(3) or fails to act on such application, or in which the IRS informs a section 501(c)(3) organization that it is considering revoking or adversely modifying its tax-exempt status, present law authorizes the organization to seek a declaratory judgment regarding its tax status (sec. 7428). Section 7428 provides a remedy in the case of a dispute involving a determination by the IRS with respect to: (1) the initial qualification or continuing qualification of an organization as a charitable organization for tax exemption purposes or for charitable contribution deduction purposes; (2) the initial classification or continuing classification of an organization as a private foundation; (3) the initial classification or continuing classification of an organization as a private operating foundation; or (4) the failure of the IRS to make a determination with respect to (1), (2), or (3). A "determination" in this context generally means a final decision by the IRS affecting the tax qualification of a charitable organization, although it also can include a proposed revocation of an organization's tax-exempt status or public charity classification. Section 7428 vests jurisdiction over controversies involving such a determination in the U.S. District Court for the District of Columbia, the U.S. Court of Federal Claims, and the U.S. Tax Court.

Prior to utilizing the declaratory judgment procedure, an organization must have exhausted all administrative remedies available to it within the IRS. An organization is deemed to have exhausted its administrative remedies at the expiration of 270 days after the date on which the request for a determination was made if the organization has taken, in a timely manner, all reasonable steps to secure such determination.

If an organization (other than a section 501(c)(3) organization) files an application for recognition of exemption and receives a favorable determination from the IRS, the determination of tax-exempt status is usually effective as of the date of formation of the organization if its purposes and activities during the period prior to the date of the determination letter were consistent with the requirements for exemption. However, if the organization files an application for recognition of exemption and later receives an adverse determination from the IRS, the IRS may assert that the organization is subject to tax on some or all of its income for open taxable years. In addition, as with charitable organizations, the IRS may revoke or modify an earlier favorable determination regarding an organization's tax-exempt status.

Under present law, a non-charity (i.e., an organization not described in section 501(c)(3)) may not seek a declaratory judgment with respect to an IRS determination regarding its tax-exempt status. The only remedies available to such an organization are to petition the U.S. Tax Court for relief following the issuance of a notice of deficiency or to pay any tax owed and sue for refund in federal district court or the U.S. Court of Federal Claims.

#### REASONS FOR CHANGE

The Committee believes that it is important to provide certainty for organizations that have sought a determination of their tax-exempt status. Thus, the Committee finds it appropriate to extend the present-law declaratory judgment procedures to all organizations that apply for tax-exempt status as organizations described in section 501(c).

#### EXPLANATION OF PROVISION

The provision extends declaratory judgment procedures similar to those currently available only to charities under section 7428 to other section 501(c) determinations. The provision limits jurisdiction over controversies involving such determinations to the United States Tax Court.[95]

#### EFFECTIVE DATE

The extension of the declaratory judgment procedures to organizations other than section 501(c)(3) organizations is effective for pleadings filed with respect to determinations made after December 31, 2001.

### G. Definition of Convention or Association of Churches

(Sec. 307 of the bill and sec. 7701 of the Code)

#### PRESENT LAW

Under present law, an organization that qualifies as a "convention or association of churches" (within the meaning of sec. 170(b)(1)(A)(i)) is not required to file an annual return,[96] is subject to the church tax inquiry and church tax examination provisions applicable to organizations claiming to be a church,[97] and is subject to certain other provisions generally applicable to churches.[98] The

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[95] This limitation currently applies to declaratory judgments relating to tax qualification for certain employee retirement plans (sec. 7476).

[96] Sec. 6033(a)(2)(A)(i).

[97] Sec. 7611(h)(1)(B).

[98] *See, e.g.,* Sec. 402(g)(8)(B) (limitation on elective deferrals); sec. 403(b)(9)(B) (definition of retirement income account); sec. 410(d) (election to have participation, vesting, funding, and certain other provisions apply to church plans); sec. 414(e) (definition of church plan); sec. 415(c)(7) (certain contributions by church plans); sec. 501(h)(5) (disqualification of certain organizations from making the sec. 501(h) election regarding lobbying expenditure limits); sec. 501(m)(3) (definition of commercial-type insurance); sec. 508(c)(1)(A) (exception from requirement to file appli-

Continued

Internal Revenue Code does not define the term "convention or association of churches."

REASONS FOR CHANGE

The term "convention or association of churches" was added to the Code to ensure that hierarchical churches and congregational churches would not be treated dissimilarly for Federal income tax purposes merely because of their organizational and governance structures. The Committee understands that some congregational church organizations have only churches as members, and that others have both churches and individuals as members. The Committee is concerned that an organization with the characteristics of a convention or association of churches, including having a substantial number of churches as members, might fail to be regarded as a convention or association of churches merely because it includes individuals in its membership. The Committee intends that a congregational church organization that otherwise constitutes a convention or association of churches not be denied recognition as such merely because its membership includes individuals as well as churches.

EXPLANATION OF PROVISION

The bill provides that an organization that otherwise is a convention or association of churches does not fail to so qualify merely because the membership of the organization includes individuals as well as churches, or because individuals have voting rights in the organization.

EFFECTIVE DATE

The provision is effective on the date of enactment.

## H. Charitable Contribution Deduction for Certain Expenses in Support of Native Alaskan Subsistence Whaling

(Sec. 308 of the bill and sec. 170 of the Code)

PRESENT LAW

In computing taxable income, individuals who do not elect the standard deduction may claim itemized deductions, including a deduction (subject to certain limitations) for charitable contributions or gifts made during the taxable year to a qualified charitable organization or governmental entity (sec. 170). Individuals who elect the standard deduction may not claim a deduction for charitable contributions made during the taxable year.

No charitable contribution deduction is allowed for a contribution of services. However, unreimbursed expenditures made incident to the rendition of services to an organization, contributions to which are deductible, may constitute a deductible contribution (Treas. Reg. sec. 1.170A–1(g)). Specifically, section 170(j) provides that no

cation seeking recognition of exempt status); sec. 512(b)(12) (allowance of up to $1,000 deduction for purposes of determining unrelated business taxable income); sec. 514(b)(3)(E) (definition of debt-financed property); sec. 3121(w)(3)(A) (election regarding exemption from social security taxes); sec. 3309(b)(1) (application of federal unemployment tax provisions to services performed in the employ of certain organizations); sec. 6043(b)(1) (requirement to file a return upon liquidation or dissolution of the organization); and sec. 7702(j)(3)(A) (treatment of certain death benefit plans as life insurance).

charitable contribution deduction is allowed for traveling expenses (including amounts expended for meals and lodging) while away from home, whether paid directly or by reimbursement, unless there is no significant element of personal pleasure, recreation, or vacation in such travel.

#### REASONS FOR CHANGE

The Committee believes that subsistence bowhead whale hunting activities are important to certain native peoples of Alaska and further charitable purposes. The Committee believes that certain expenses paid by individuals recognized as whaling captains by the Alaska Eskimo Whaling Commission in the conduct of sanctioned whaling activities conducted pursuant to the management plan of that Commission should be deductible as charitable contributions even though they are paid other than directly to a charitable organization.

#### EXPLANATION OF PROVISION

The provision allows certain individuals to claim a deduction under section 170 not exceeding $7,500 per taxable year for certain expenses incurred in carrying out sanctioned whaling activities. The deduction is available only to an individual who is recognized by the Alaska Eskimo Whaling Commission as a whaling captain charged with the responsibility of maintaining and carrying out sanctioned whaling activities. The deduction is available for reasonable and necessary expenses paid by the taxpayer during the taxable year for: (1) the acquisition and maintenance of whaling boats, weapons, and gear used in sanctioned whaling activities, (2) the supplying of food for the crew and other provisions for carrying out such activities, and (3) storage and distribution of the catch from such activities. The Committee intends that the Secretary shall require that the taxpayer substantiate deductible expenses by maintaining appropriate written records that show, for example, the time, place, date, amount, and nature of the expense, as well as the taxpayer's eligibility for the deduction. In addition, the Committee believes that it is appropriate for the taxpayer to provide such substantiation as part of the taxpayer's income tax return, to the extent provided by the Secretary.

For purposes of the provision, the term "sanctioned whaling activities" means subsistence bowhead whale hunting activities conducted pursuant to the management plan of the Alaska Eskimo Whaling Commission.

#### EFFECTIVE DATE

The provision applies to expenses paid after December 31, 2002, in taxable years ending after such date.

### I. PAYMENTS BY CHARITABLE ORGANIZATIONS TO VICTIMS OF WAR ON TERRORISM

(Sec. 309 of the bill)

#### PRESENT LAW

In general, organizations described in section 501(c)(3) of the Code are exempt from taxation. Contributions to such organizations generally are tax deductible.[99] Section 501(c)(3) organizations must be organized and operated exclusively for exempt purposes and no part of the net earnings of such organizations may inure to the benefit of any private shareholder or individual. An organization is not organized or operated exclusively for one or more exempt purposes unless the organization serves a public rather than a private interest. Thus, an organization described in section 501(c)(3) generally must serve a charitable class of persons that is indefinite or of sufficient size.

Tax-exempt private foundations are a type of organization described in section 501(c)(3) and are subject to special rules. Private foundations are subject to excise taxes on acts of self-dealing between the private foundation and a disqualified person with respect to the foundation.[100] For example, it is self-dealing if assets of a private foundation are used for the benefit of a disqualified person, such as a substantial contributor to the foundation or a person in control of the foundation, and the benefit is not incidental or tenuous.

### REASONS FOR CHANGE

The Committee believes that payments by charities to members of the Armed Forces of the United States (and their immediate families) made by reason of death, injury, wounding or illness and incurred as a result of our nation's military response to the terrorist attacks of September 11, 2001, should be treated as consistent with the charity's exempt purpose, to the extent the payments are made in good faith and pursuant to a reasonable and objective formula that is consistently applied.

### EXPLANATION OF PROVISION

The bill provides that organizations described in section 501(c)(3) that make certain payments are not required to make a specific assessment of need for the payments to be related to the purpose or function constituting the basis for the organization's exemption, provided that the organization makes the payments in good faith and uses an objective formula that is consistently applied in making the payments.

The provision applies to payments to a member of the Armed Forces of the United States (as defined in section 7701(a)(15)), or to a member of such person's immediate family (including spouses, parents, children, and foster children), by reason of the death, injury, wounding, or illness of a member of the Armed Forces of the United States that was incurred as a result of the military response of the United States to the terrorist attacks against the United States on September 11, 2001. As under present law, such payments must be for public and not private benefit and therefore must serve a charitable class. For example, a charitable organization that assists the families of members of the Armed Forces killed in the line of duty may make pro-rata distributions to the families of those killed, even though the specific financial needs of each family are not directly considered. Similarly, if the amount of a distribution is based on the number of dependents of a charitable

[99] Sec. 170.
[100] Sec. 4941.

class of persons killed in the military response to the attacks and this standard is applied consistently among distributions, the specific needs of each recipient do not have to be taken into account. However, it is not appropriate for a charity to make pro-rata payments based on the recipients' living expenses before the harm occurred if the result generally provides significantly greater assistance to persons in a better position to provide for themselves than to persons with fewer financial resources. Although such a distribution might be based on objective criteria, it is not a reasonable formula for distributing assistance in an equitable manner. Similarly, although specific assessments of need are not required, payments that do not further public purposes are not permitted. The provision does not change the substantive standards for exemption under section 501(c)(3), including the prohibition on private inurement. The provision also provides that if a private foundation makes payments under the conditions described above, the payment is not treated as made to a disqualified person for purposes of section 4941.

#### EFFECTIVE DATE

The provision applies to payments made after the date of enactment and before September 11, 2003.

### J. MODIFY RULES GOVERNING TAX-EXEMPT BONDS FOR SECTION 501(C)(3) ORGANIZATIONS AS APPLIED TO ORGANIZATIONS ENGAGED IN TIMBER CONSERVATION ACTIVITIES

(Sec. 310 of the bill and sec. 145 of the Code)

#### PRESENT LAW

Interest on State or local government bonds is tax-exempt when the proceeds of the bonds are used to finance activities carried out by or paid for by those governmental units. Interest on bonds issued by State or local governments acting as conduit borrowers for private businesses is taxable unless a specific exception is included in the Code. One such exception allows tax-exempt bonds to be issued to finance activities of non-profit organizations described in Code section 501(c)(3) ("qualified 501(c)(3) bonds").

Qualified 501(c)(3) bonds may be issued only to finance the activities that qualify the organization for tax-exemption, as opposed to unrelated business activities of these organizations. If the bonds are issued to finance property that is intended to be sold to a private business while the bonds are outstanding, bond interest may not qualify for tax-exemption. Similarly, if the property is in fact sold, bond interest may become retroactively taxable unless remedial actions specified in Treasury Department regulations are taken. An example of such a situation would be qualified 501(c)(3) bonds issued to finance the purchase of land and standing timber when the timber was to be sold.

As is true of governmental activities receiving tax-exempt financing, section 501(c)(3) organizations are restricted in the arrangements they may have with private businesses relating to control and use of bond-financed property.

REASONS FOR CHANGE

The Committee notes that thousands of acres of productive forest are being lost to urban uses. The Committee believes it is appropriate to offer greater protection of areas of particular environmental sensitivity and open space, while at the same time maintaining viable forest operations and jobs near growing urban areas. This provision will give qualified 501(c)(3) organizations the flexibility to acquire and preserve larger tracts of forest land by lowering the financing costs. Thus, the provision should reduce the need to acquire these lands on a smaller, more piecemeal basis. Further, by allowing trees to be harvested to cover the bond payments, the provision will provide jobs, while subjecting the land to a conservation easement will preserve areas of particular environmental sensitivity and open space.

EXPLANATION OF PROVISION

The provision modifies the rules governing issuance of qualified 501(c)(3) bonds to permit the issuance of long-term bonds for the acquisition of land and timber associated with such land subject to a conservation restriction. Under the provision, the bonds will not fail to be qualified 501(c)(3) bonds if the timber is sold or leased to, or otherwise used by, an unrelated person to the extent that such sale, leasing, or other use does not constitute an unrelated trade or business, and so long as the other requirements of the provision are met. In addition, these bonds will not be qualified 501(c)(3) bonds unless the seller of the land and timber property that is to be acquired with the bond proceeds irrevocably elects not to exclude from income any portion of the gain on the sale of such property made for qualifying conservation purposes under section 121A of the Code as added by section 107 of the bill.

Under the provision, section 501(c)(3) organizations may enter into certain otherwise prohibited timber management arrangements with private businesses without losing tax-exemption on bonds used to finance the property and timber provided that those arrangements do not constitute an unrelated trade or business with respect to the organization. Similarly, the bonds may be issued on a tax-exempt basis notwithstanding plans by the section 501(c)(3) organization to harvest and sell standing timber on land being acquired.

The provision imposes a national limitation of $2 billion on the aggregate amount of bonds that may be issued pursuant to this provision. This volume limitation, for the period October 1, 2002, to December 31, 2005, will be allocated by the Department of Treasury to qualified section 501(c)(3) organizations based on criteria established by the Department of Treasury (after consultation with appropriate Federal, State, and local officials). The Committee anticipates that the criteria will be based on, among other factors, the environmental merit and economic viability of a particular project, rather than an attempt to achieve geographical balance in making the allocations. The Committee further expects that no later than 90 days after the date of enactment, the Department of Treasury will issue guidance that specifies (1) how section 501(c)(3) organizations are to apply for an allocation and (2) the procedure through which such allocations are to be made to the appropriate organizations.

EFFECTIVE DATE

The provision is effective for bonds issued after September 30, 2002 and before January 1, 2006.

## K. Provide Tax Exemption for Organizations Created by a State To Provide Property and Casualty Insurance Coverage for Property for Which Such Coverage Is Otherwise Unavailable

(Sec. 311 of the bill and sec. 501(c)(28) of the Code)

PRESENT LAW

*In general*

A life insurance company is subject to tax on its life insurance company taxable income, which is its life insurance income reduced by life insurance deductions (sec. 801). Similarly, a property and casualty insurance company is subject to tax on its taxable income, which is determined as the sum of its underwriting income and investment income (as well as gains and other income items) (sec. 831). Present law provides that the term "corporation" includes an insurance company (sec. 7701(a)(3)).

In general, the Internal Revenue Service ("IRS") takes the position that organizations that provide insurance for their members or other individuals are not considered to be engaged in a tax-exempt activity. The IRS maintains that such insurance activity is either (1) a regular business of a kind ordinarily carried on for profit, or (2) an economy or convenience in the conduct of members' businesses because it relieves the members from obtaining insurance on an individual basis.

Certain insurance risk pools have qualified for tax exemption under Code section 501(c)(6). In general, these organizations (1) assign any insurance policies and administrative functions to their member organizations (although they may reimburse their members for amounts paid and expenses); (2) serve an important common business interest of their members; and (3) must be membership organizations financed, at least in part, by membership dues.

State insurance risk pools may also qualify for tax-exempt status under section 501(c)(4) as a social welfare organization or under section 115 as serving an essential governmental function of a State. In seeking qualification under section 501(c)(4), insurance organizations generally are constrained by the restrictions on the provision of "commercial-type insurance" contained in section 501(m). Section 115 generally provides that gross income does not include income derived from the exercise of any essential governmental function and accruing to a State or any political subdivision thereof.

Certain specific provisions provide tax-exempt status to organizations meeting statutory requirements.

*Health coverage for high-risk individuals*

Section 501(c)(26) provides tax-exempt status to any membership organization that is established by a State exclusively to provide coverage for medical care on a nonprofit basis to certain high-risk individuals, provided certain criteria are satisfied. The organization may provide coverage for medical care either by issuing insurance itself or by entering into an arrangement with a health maintenance organization ("HMO").

High-risk individuals eligible to receive medical care coverage from the organization must be residents of the State who, due to a pre-existing medical condition, are unable to obtain health coverage for such condition through insurance or an HMO, or are able to acquire such coverage only at a rate that is substantially higher than the rate charged for such coverage by the organization. The State must determine the composition of membership in the organization. For example, a State could mandate that all organizations that are subject to insurance regulation by the State must be members of the organization.

The provision further requires the State or members of the organization to fund the liabilities of the organization to the extent that premiums charged to eligible individuals are insufficient to cover such liabilities. Finally, no part of the net earnings of the organization can inure to the benefit of any private shareholder or individual.

*Workers' compensation reinsurance organizations*

Section 501(c)(27)(A) provides tax-exempt status to any membership organization that is established by a State before June 1, 1996, exclusively to reimburse its members for workers' compensation insurance losses, and that satisfies certain other conditions. A State must require that the membership of the organization consist of all persons who issue insurance covering workers' compensation losses in such State, and all persons and governmental entities who self-insure against such losses. In addition, the organization must operate as a nonprofit organization by returning surplus income to members or to workers' compensation policyholders on a periodic basis and by reducing initial premiums in anticipation of investment income.

*State workmen's compensation act companies*

Section 501(c)(27)(B) provides tax-exempt status for any organization that is created by State law, and organized and operated exclusively to provide workmen's compensation insurance and related coverage that is incidental to workmen's compensation insurance, and that meets certain additional requirements. The workmen's compensation insurance must be required by State law, or be insurance with respect to which State law provides significant disincentives if it is not purchased by an employer (such as loss of exclusive remedy or forfeiture of affirmative defenses such as contributory negligence). The organization must provide workmen's compensation to any employer in the State (for employees in the State or temporarily assigned out-of-State) seeking such insurance and meeting other reasonable requirements. The State must either extend its full faith and credit to the initial debt of the organization or provide the initial operating capital of such organization. For this purpose, the initial operating capital can be provided by providing the proceeds of bonds issued by a State authority; the bonds may be repaid through exercise of the State's taxing authority, for example. For periods after the date of enactment, either the assets of the organization must revert to the State upon dissolution, or State law must not permit the dissolution of the organization absent an act of the State legislature. Should dissolution of the organization become permissible under applicable State law, then the requirement that the assets of the organization revert to the State upon dissolution applies. Finally, the majority of the board of directors (or comparable oversight body) of the organization must be appointed by an official of the executive branch of the State or by the State legislature, or by both.

REASONS FOR CHANGE

The Committee understands that certain types of insurance to support governmental programs to prepare for or mitigate the effects of natural catastrophic events (such as hurricanes) may be limited or unavailable at reasonable rates in the authorized insurance market in some States. The Committee believes it is appropriate to provide tax-exempt status to certain types of associations that provide property and casualty insurance for windstorm, hail and fire damage to property located within a State if the State has determined that coverage in the authorized insurance market is in fact not reasonably available to a substantial number of insurable real properties.

EXPLANATION OF PROVISION

The provision provides tax-exempt status for any association created before January 1, 1999, by State law and organized and operated exclusively to provide property and casualty insurance coverage for windstorm, hail and fire damage to property located within the State for which the State has determined that coverage in the authorized insurance market is not reasonably available to a substantial number of insurable real properties, provided certain requirements are met.

Under the provision, no part of the net earnings of the association may inure to the benefit of any private shareholder or individual. Except as provided in the case of dissolution, no part of the assets of the association may be used for, or diverted to, any purpose other than: (1) to satisfy, in whole or in part, the liability of the association for, or with respect to, claims made on policies written by the association; (2) to invest in investments authorized by applicable law; (3) to pay reasonable and necessary administration expenses in connection with the establishment and operation of the association and the processing of claims against the association; or (4) to make remittances pursuant to State law to be used by the State to provide for the payment of claims on policies written by the association, purchase reinsurance covering losses under such policies, or to support governmental programs to prepare for or mitigate the effects of natural catastrophic events. The provision requires that the State law governing the association permit the association to levy assessments on insurance companies authorized to sell property and casualty insurance in the State, or on property and casualty insurance policyholders with insurable interests in property located in the State to fund deficits of the association, including the creation of reserves. The provision requires that the plan of operation of the association be subject to approval by the chief executive officer or other official of the State, by the State legislature, or both. In addition, the provision requires that the assets of the association revert upon dissolution to the State, the State's designee, or an entity designated by the State law governing the association, or that State law not permit the dissolution of the association.

The provision provides a special rule in the case of any entity or fund created before January 1, 1999, pursuant to State law and organized and operated exclusively to receive, hold, and invest remittances from an association exempt from tax under the provision, to make disbursements to pay claims on insurance contracts issued by the association, and to make disbursements to support governmental programs to prepare for or mitigate the effects of natural catastrophic events. The special rule provides that the entity or fund may elect to be disregarded as a separate entity and be treated as part of the association exempt from tax under the provision, from which it receives such remittances. The election is required to be made no later than 30 days following the date on which the association is determined to be exempt from tax under the provision, and would be effective as of the effective date of that determination.

An organization described in the provision is treated as having unrelated business taxable income ("UBIT") in the amount of its taxable income (computed as if the organization were not exempt from tax under the provision), if at the end of the immediately preceding taxable year, the organization's net equity exceeds 15 percent of the total coverage in force under insurance contracts issued by the organization and outstanding at the end of that preceding year.

Under the provision, no income or gain is recognized solely as a result of the change in status to that of an association exempt from tax under the provision.

#### EFFECTIVE DATE

The provision is effective for taxable years beginning after December 31, 2002. No inference is intended as to the tax status under present law of associations described in the provision.

### L. CONFORM PROVISIONS RELATING TO ARBITRAGE TREATMENT OF CERTAIN UNIVERSITY FUND TO STATE CONSTITUTIONAL AMENDMENTS

(Sec. 312 of the bill)

#### PRESENT LAW

In general, present law tax-exempt arbitrage restrictions provide that interest on a State or local government bond is not eligible for tax-exemption if the proceeds are invested, directly or indirectly, in materially higher yielding investments or if the debt service on the bond is secured by or paid from (directly or indirectly) such investments. An exception, enacted in 1984, provides that the pledge of income from investments in a permanent university fund ("the Fund") established under a provision of a State constitution adopted in 1876 as security for a limited amount of tax-exempt bonds will not cause interest on those bonds to be taxable. The terms of this exception are limited to State constitutional or statutory restrictions in effect as of October 9, 1969.

The Fund consists of certain State lands that were set aside for the benefit of higher education, the income from mineral rights to these lands, and certain other earnings on Fund assets. The State constitution directs that monies held in the Fund are to be invested in interest-bearing obligations and other securities. The constitution does not permit the expenditure or mortgage of the Fund for any purpose. Income from the Fund is apportioned between two university systems operated by the State. Tax-exempt bonds issued by the two university systems are secured by and payable from the income of the Fund. These bonds are used to finance buildings and other permanent improvements for the universities.

The State constitutional rules governing the Fund have been modified with regard to the manner in which amounts in the Fund are paid for the benefit of the two university systems.

#### REASONS FOR CHANGE

The Committee understands that the State constitutional amendments have the effect of permitting the Fund to make annual distributions in a manner similar to standard university endowment funds, rather than the previous practice which tied distributions to annual income performance, which can create a variable pattern of distributions. The Committee does not believe that the Fund should lose the benefits of the 1984 exception from the tax-exempt bond arbitrage restrictions by adopting a sounder, more modern approach to the management of Fund distributions.

#### EXPLANATION OF PROVISION

The 1984 exception is conformed to the present State constitutional provisions governing the Fund's ability to make annual distributions in a manner similar to standard university endowment funds. Limitations on the aggregate amount of bonds that may benefit from the exception are not modified.

#### EFFECTIVE DATE

The provision is effective on the date of enactment.

### M. MATCHING GRANTS TO LOW-INCOME TAXPAYER CLINICS FOR RETURN PREPARATION

(S(sec. 313 of the bill)

#### PRESENT LAW

The Secretary is authorized to provide up to $6 million per year in matching grants to certain low-income taxpayer clinics that represent low-income taxpayers in controversies with the IRS or that operate programs to inform individuals for whom English is a second language about their tax-related rights and responsibilities.[101]

[101] Sec. 7526.

### REASONS FOR CHANGE

The Committee believes that the low-income taxpayer clinic program should be expanded to provide grants to assist low-income taxpayers in the preparation of their Federal tax returns.

### EXPLANATION OF PROVISION

The provision authorizes the Secretary to create a separate grant program to provide up to $10 million per year in matching grants to not for profit organizations that assist low-income taxpayers in the preparation of their Federal tax returns.

### EFFECTIVE DATE

The provision is effective on the date of enactment.

## N. Increase Percentage Limits for Certain Employer-Related Scholarship Programs

(Sec. 314 of the bill)

### PRESENT LAW

Gross income does not include any amount received as a qualified scholarship by an individual who is a candidate for a degree at an educational organization (sec. 117(a)). For this purpose, a scholarship generally means an amount paid or allowed to, or for the benefit of, a student to aid that student in pursuing studies.[102] However, an amount paid or allowed to, or on behalf of, an individual to enable the individual to pursue studies is not treated as a scholarship if the amount represents compensation for past, present, or future services.[103] The determination of whether an amount is properly treated as a scholarship or compensation for services is made in light of all the relevant facts and circumstances.

Present law imposes excise taxes on the taxable expenditures of a private foundation.[104] A taxable expenditure includes, among other things, any amount paid or incurred by a private foundation as a grant to an individual for travel, study, or other similar purposes by such individual, unless such grant is awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the Secretary.[105] In the case of individual grants to be made as scholarships or fellowships, the private foundation must demonstrate to the satisfaction of the Secretary that the grant: (1) constitutes a scholarship or fellowship which would be subject to the provisions of section 117(a),[106] and (2) is to be used for study at an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on.[107]

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[102] Treas. Reg. sec. 1.117–3(a).
[103] Treas. Reg. sec. 1.117–4(c).
[104] Secs. 4945(a) and (b).
[105] Secs. 4945(d)(3) and (g).
[106] For the purpose of section 4945(g), the term "scholarship or fellowship" refers to the provisions of section 117(a) as in effect before the Tax Reform Act of 1986. Sec. 4945(g)(1).
[107] Secs. 4945(g)(1) and 170(b)(1)(A)(ii).

Private foundations may in the course of their activities make scholarship or fellowship grants to individuals to be used for educational purposes. However, a private foundation's grant program may not be designed or administered to the end of providing compensation, an employment incentive, or an employee fringe benefit to persons employed by the foundation or by another employer (including, for example, employees of a "related" employer organization). Revenue Procedure 76–47 provides advance approval guidelines to determine whether grants made by private foundations under employer-related grant programs to an employee or to a child of an employee of the employer to which the program relates is considered a scholarship or fellowship grant subject to the provisions of section 117(a).[108] To the extent that such grants are considered scholarships or fellowships under these guidelines, the Secretary will assume the grants are not taxable expenditures subject to section 4945 taxes. Educational grants that are not scholarships or fellowships under these guidelines might, depending upon the circumstances, lead to a loss of the private foundation's exempt status.

Under Revenue Procedure 76–47, a grant made under an employer-related grant program that satisfies seven conditions and a percentage test is considered a scholarship or fellowship.[109] Grants awarded to children of employees and to employees are considered as having been awarded under separate programs for purposes of the revenue procedure, regardless of whether they are awarded under separately administered programs. All such grants must satisfy each of the seven conditions to obtain advance approval of the grant program. The percentage test applicable to grants to children of employees requires that the number of grants awarded not exceed either 25 percent of the eligible applicants considered by the selection committee in selecting grant recipients or 10 percent of those eligible for grants (regardless of whether they submitted grant applications). The percentage test applicable to grants to employees requires that the number of grants awarded not exceed 10 percent of eligible applicants considered by the selection committee in selecting grant recipients. If the seven conditions are met, but the relevant percentage test is not satisfied, then the question of whether the grants constitute scholarships or fellowships is based upon all of the facts and circumstances.

Similar requirements and percentage limits apply to determine whether educational loans made by a private foundation under an

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[108] Rev. Proc. 76–47, 1976–2 C.B. 670. The revenue procedure defines an employer-related program as a program that treats some or all of the employees, or children of some or all of the employees, of an employer as a group from which grantees of some or all of the grants will be selected, limits the potential grantees from some or all of the grants to individuals who are employees or children of employees of an employer, or otherwise gives such individuals a preference or priority over others in being selected as grantees.

[109] The seven conditions include: (1) the program must not be used to recruit employees, to induce employees to continue their employment, or to compel a course of action sought by the employer; (2) the selection of grant recipients must be made by a committee consisting of independent individuals; (3) the program must impose identifiable minimum requirements for grant eligibility; (4) the selection of grant recipients must be based solely upon substantial objective standards that are completely unrelated to employment and to the employer's line of business; (5) a grant may not be terminated because the recipient or the recipient's parent terminates employment with the employer; (6) the courses of study for which grants are available must not be limited to those would be of particular benefit to the employer or the foundation; and (7) the terms of the grant and the courses of study for which grants are available must meet all other requirements of section 117 and must be consistent with the disinterested purpose of education for personal benefit rather than for the benefit of the employer or the foundation.

employer-related loan program are taxable expenditures.[110] If an employer-related program encompasses educational loans and scholarship or fellowship grants to the same group of eligible employees or employees' children, the percentage tests applicable to the loan program apply to the total number of individuals receiving combined grants of scholarships, fellowships, and educational loans.[111]

### REASONS FOR CHANGE

The Committee believes that the quantitative limits set forth in Revenue Procedure 76–47 are too low for employer-related grant programs that provide scholarships or fellowships to children of employees. The Committee believes that higher percentage limits will encourage increases in grants made for educational purposes. The Committee also believes that the higher percentage limits should be available only in cases where the foundation maintains a comparable grant program for children who are not affiliated with the employer to which the employer-related grant program relates.

### EXPLANATION OF PROVISION

The percentage limits set forth in Revenue Procedure 76–47 for grants to children of employees are increased to 35 percent of eligible applicants considered by the selection committee or 20 percent of those eligible for the grants. However, the higher percentage limits are available only if the private foundation meets the other requirements of the Revenue Procedure and demonstrates that the foundation provides a comparable number and aggregate amount of grants during the same grant-program year to children who are not children of former or current employees of any employer to which an employer-related grant program relates. The provision does not amend the percentage limits for grants to employees, or the percentage limits of Revenue Procedure 80–39 relating to loan programs or programs which encompass both loans and grants.

### EFFECTIVE DATE

Revenue Procedure 76–47 is to be amended effective for grants awarded after December 31, 2002.

## Title IV. Social Services Block Grant

(Secs. 401–403 of the bill)

### PRESENT LAW

Social Services Block Grant Funding ("SSBG"), also known as "Title XX" (because it is Title XX of the Social Security Act), is a flexible funding stream, providing states with resources to support a variety of social services. SSBG funds can be used to assist the elderly and disabled so that they do not need to enter institutions, to prevent child and elder abuse, to provide child care, to promote and support adoption, and for several other services. There are certain specified limitations so that SSBG cannot fund most medical

[110] Rev. Proc. 80–39, 1980–2 C.B. 772.
[111] *Id.*

care, for example, or cash welfare payments. It is a mandatory capped entitlement, distributed by a population-based formula among the states.

States use SSBG in differing ways. Much of the funding supports local social service providers, including faith-related organizations, through contracts with state and local governments. Overall, in fiscal year 1999, SSBG spending was as follows: 13.4 percent for "prevention" and case management; 13 percent for day care; 12.4 percent for child and adult protective services; 10.9 percent for foster care; 7.4 percent for home-based services. There are several other categories in the expenditure data as well.

Prior to the 1996 welfare reform law, SSBG was funded at $2.8 billion. That legislation reduced SSBG to $2.38 billion, as part of achieving budgetary savings, and permitted states to transfer up to 10 percent of their new Temporary Assistance for Needy Families (TANF) welfare block grant allocations to SSBG. (Any transferred funds are required to be spent on behalf of families below 200 percent of poverty.) In 1998, as part of the TEA–21 highway legislation, SSBG funding as further reduced, declining to $1.7 billion for fiscal year 2001 and fiscal year 2002. The TANF transfer was further limited to 4.25 percent.

#### REASONS FOR CHANGE

The Committee believes that an increase in funding for SSBG will allow social service organizations to provide more assistance to families in need and disadvantaged individuals. The flexible nature of SSBG permits states and localities to choose their own priorities for the uses of the increased funding.

#### EXPLANATION OF PROVISION

The provision increases SSBG funding to $1.975 billion for fiscal year 2003 and $2.8 billion for fiscal year 2004. In addition, the TANF transfer limit is restored to 10 percent. These two measures provide additional resources to faith-related social service organizations. Finally, the Secretary of HHS is required to submit annual reports on SSBG expenditures to the Congress.

#### EFFECTIVE DATE

The provision is effective for amounts made available for fiscal year 2003 and for amounts made available each fiscal year thereafter. The provision requiring annual reports applies to such reports with respect to fiscal year 2002 and each fiscal year thereafter.

## Title V. Individual Development Accounts

(Secs. 501–511 of the bill)

#### PRESENT LAW

Individual development accounts were first authorized by the Personal Work and Responsibility Act of 1996. In 1998, the Assets for Independence Act established a five-year $125 million demonstration program to permit certain eligible individuals to open and make contributions to an individual development account. Contributions by an individual to an individual development account do not receive a tax preference but are matched by contributions from a State program, a participating nonprofit organization, or other "qualified entity." The IRS has ruled that matching contributions by a qualified entity are a gift and not taxable to the account owner.[112] The qualified entity chooses a matching rate, which must be between 50 and 400 percent. Withdrawals from individual development accounts can be made for certain higher education expenses, a first home purchase, or small-business capitalization expenses. Matching contributions (and earnings thereon) typically are held separately from the individuals' contributions (and earnings thereon) and must be paid directly to a mortgage provider, university, or business capitalization account at a financial institution. The Department of Health and Human Services administers the individual development account program.

REASONS FOR CHANGE

The Committee recognizes that the rate of private savings in the United States is too low. In particular, many low-income individuals either have inadequate savings or no savings at all. The Committee believes that a tax-subsidized match by financial institutions may help encourage more savings by low-income working individuals. The program is intended to encourage a pattern of individual savings and wealth accumulation. Finally, the Committee believes that the program will allow individuals to use their savings for three important purposes: (1) to afford better educations; (2) to achieve home ownership; and (3) to start their own businesses.

EXPLANATION OF PROVISION

The bill provides for a nonrefundable tax credit for an eligible entity (i.e., a qualified financial institution) that has an individual development account program in a taxable year. The tax credit equals the amount of matching contributions made by the eligible entity under the program (up to $500 per taxable year) plus $50 for each individual development account maintained during the taxable year under the program. Except in the first year that each account is open, the $50 credit is available only for accounts with a balance of more than $100 at year-end (including matching funds). No deduction or other credit is available with respect to the amount of matching funds taken into account in determining the credit.

The credit applies with respect to the first 300,000 individual development accounts opened before January 1, 2011, and with respect to matching funds for participant contributions that are made after December 31, 2003, and before January 1, 2011. An account is considered open if at any time the balance in the account exceeds $100 (including matching amounts). The individual development accounts will be available on the following basis: (1) a maximum of 100,000 accounts may be opened after December 31, 2003 and before January 1, 2007; (2) a second 100,000 accounts may be opened after December 31, 2006 and before January 1, 2009, if the entire 100,000 of authorized accounts are opened after December 31, 2003 and before January 1, 2007 and the Secretary of the Treasury determines that these accounts are being reasonably and

[112] Rev. Rul. 99–44, 1999–2 C.B. 549.

responsibly administered;[113] and (3) a third 100,000 accounts may be opened after December 31, 2008 and before January 1, 2011 if the previous cohorts of 100,000 accounts have been opened under the schedule described above and the Secretary of the Treasury makes a four-part determination. Specifically, the Secretary will have to determine: (1) that all previously opened accounts have been reasonably and responsibly administered to date; (2) that the individual development account program has increased net savings of participants in the program; (3) whether participants in the individual development account program have increased Federal income tax liability and decreased utilization of Federal assistance programs (e.g., Temporary Assistance to Needy Families and Food Stamps) relative to similarly situated individuals that did not participate in the individual development account program; and (4) that the sum of the increased Federal tax liability and reduction of Federal assistance program benefits to participants in the individual development account program is greater than the cost of the individual development account program to the Federal government. If the Secretary finds that any of the four determinations has not been satisfied, the Congress will have the discretion to authorize the third 100,000 accounts after the Secretary makes his or her report to the Congress regarding the four determinations. The third 100,000 accounts must be equally divided among the States. For all accounts, the Secretary will take steps to encourage use of individual development accounts in rural areas.

Nonstudent U.S. citizens or lawful permanent residents between the ages of 18 and 60 (inclusive) who meet certain income requirements are eligible to open and contribute to an individual development account. The income limit for participation is modified adjusted gross income of $18,000 for single filers, $38,000 for joint filers, and $30,000 for head-of-household filers.[114] Eligibility in a taxable year generally is based on the previous year's modified adjusted gross income and circumstances (e.g., status as a student). Modified adjusted gross income is adjusted gross income plus certain items that are not includible in gross income. The items added are tax-exempt interest and the amounts otherwise excluded from gross income under Code sections 86, 893, 911, 931, and 933 (relating to the exclusion of certain social security and Tier 1 railroad retirement benefits; the exclusion of compensation of employees of foreign governments and international organizations; the exclusion of income of U.S. citizens or residents living abroad; the exclusion of income for residents of Guam, American Samoa, and the Northern Mariana Islands; and the exclusion of income for residents of Puerto Rico). The income limits are adjusted for inflation after 2003. These amounts are rounded to the nearest multiple of 50 dollars.

Under the bill, an individual development account must: (1) be owned by the eligible individual for whom the account was established; (2) consist only of cash contributions; (3) be held by a person authorized to be a trustee of any individual retirement account

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[113] If less than 100,000 accounts are opened before January 1, 2007, then the number of accounts that can be opened after December 31, 2006 and before January 1, 2009 will be reduced to the lesser of 75,000 accounts of three times the number of accounts opened before January 1, 2007.

[114] Married taxpayers filing separate returns are not eligible to open an IDA or to receive matching funds for an IDA that is already open.

under section 408(a)(2); and (4) not commingle account assets with other property (except in a common trust fund or common investment fund). These requirements must be reflected in the written governing instrument creating the account. The entity establishing the program is required to maintain separate accounts for the individual's contributions (and earnings thereon) and for matching funds and earnings thereon (a "parallel account").

Contributions to individual development accounts by individuals are not deductible and earnings thereon are taxable to the account holder. Matching contributions and earnings thereon are not taxable to the account holder.

The bill permits individuals to withdraw amounts from an individual development account for qualified expenses of the account owner, owner's spouse, or dependents as well as for nonqualified expenses, subject to certain restrictions. Qualified expenses include qualified: (1) higher education expenses (as generally defined in section 529(e)(3)); (2) first-time homebuyer costs (as generally provided in section 72 (t)(8)); (3) business capitalization or expansion costs (expenditures made pursuant to a business plan that has been approved by the financial institution); (4) rollovers of the balance of the account (including the parallel account) to another individual development account for the benefit of the same owner; and (5) final distributions in the case of a deceased account owner. Withdrawals for qualified expenses must be made from funds that have been in the account for at least one year and must be paid directly to the unrelated third party to whom the amount is due, except in the case of expenses under a qualified business plan, rollover, or final distribution. Such withdrawals generally are not permitted until the account owner completes a financial education course offered by a qualified financial institution. The Secretary of the Treasury (the "Secretary") is required to establish minimum standards for such courses. Withdrawals for nonqualified expenses may result in the account owner's forfeiture of matching funds. The amount of the forfeiture is the lesser of: (1) an amount equal to the nonqualified withdrawal; or (2) the excess of the amount in the parallel account (excluding earnings on matching funds) over the amount remaining in the individual development account after the nonqualified withdrawal. If the individual development account (or a portion thereof) is pledged as security for a loan, then the portion so used will be treated as a nonqualified withdrawal and will result in the loss of an equal amount of matching funds from the parallel account.

The qualified entity administering the individual development account program generally is required to make quarterly payments of matching funds to a parallel account on a dollar-for-dollar basis for the first $500 contributed by the account owner in a taxable year. Matching funds also may be provided by State, local, or private sources. Balances of the individual development account and parallel account must be reported annually to the account owner. If an account owner ceases to meet eligibility requirements, matching funds generally may not be contributed during the period of ineligibility. Any amount withdrawn from a parallel account is not includible in an eligible individual's gross income or the account sponsor's gross income.

Qualified entities administering a qualified program are required to report to the Secretary that the program is administered in accordance with legal requirements. If the Secretary determines that the program was not so operated, the Secretary would have the power to terminate the program. Qualified entities also are required to report annually to the Secretary information about: (1) the number of individuals making contributions to individual development accounts; (2) the amounts contributed by such individuals; (3) the amount of matching funds contributed; (4) the amount of funds withdrawn and for what purpose; (5) balance information; and (6) any other information that the Secretary deems necessary. The fiduciary requirements of Title 12 of the United States Code with respect to insured depository institutions and insured credit unions (as defined therein) continue to apply to those financial institutions participating in the individual development account program.

The Secretary is authorized to prescribe necessary regulations, including rules to permit individual development account program sponsors to verify eligibility of individuals seeking to open accounts and rules to allow a financial institution (e.g., a tax-exempt credit union) to transfer those credits to another taxpayer. The Secretary also is authorized to provide rules to recapture credits claimed with respect to individuals who forfeit matching funds.

The Secretary must submit annual reports to Congress on the status of the qualified individual account program.

EFFECTIVE DATE

The provision is effective for taxable years ending after December 31, 2003, and beginning before January 1, 2011.

## Title VI. Revenue Provisions

### A. Tax Shelter Transparency Requirements

#### 1. Penalty for failure to disclose reportable transactions (sec. 601 of the bill and new sec. 6707A of the Code)

PRESENT LAW

Regulations under section 6011 require a taxpayer to disclose with its tax return certain information with respect to each "reportable transaction" in which the taxpayer participates.[115]

There are two categories of reportable transactions. The first category includes any transaction that is the same as (or substantially similar to)[116] a transaction that is specified by the Treasury Department as a tax avoidance transaction whose tax benefits are subject to disallowance under present law (referred to as a "listed transaction"). A taxpayer must disclose any listed transaction that

[115] Temp. Treas. Reg. sec. 1.6011–4T; Prop. Treas. Reg. sec. 1.6011–4. Effective June 14, 2002, the regulations were modified to require non-corporate taxpayers (i.e., individuals, trusts, partnerships, and S corporations) to disclose their participation in reportable transactions that have been specified by the Treasury Department as "listed" transactions. *See* T.D. 9000, 67 Fed. Reg. 41,324 (June 18, 2002). Disclosure of other reportable transactions under the regulations continues to be limited to corporate taxpayers.

[116] The recently-modified regulations clarify that the term "substantially similar" includes any transaction that is expected to obtain the same or similar types of tax benefits and that is either factually similar or based on the same or similar tax strategy. Also, the term must be broadly construed in favor of disclosure. *See* T.D. 9000, 67 Fed. Reg. 41,324 (June 18, 2002).

is expected to reduce the taxpayer's Federal income tax liability by more than $1 million in any single taxable year or more than $2 million in any combination of years.[117]

The second category of reportable transactions includes transactions that are expected to reduce a taxpayer's Federal income tax liability by more than $5 million in any single year or $10 million in any combination of years and that have at least two of the following characteristics: (1) the taxpayer has participated in the transaction under conditions of confidentiality; (2) the taxpayer has obtained or been provided with contractual protection against the possibility that part or all of the intended tax benefits from the transaction will not be sustained; (3) the promoters of the transaction have received or are expected to receive fees or other consideration with an aggregate value in excess of $100,000, and such fees are contingent on the taxpayer's participation; (4) the transaction results in a reported book/tax difference in excess of $5 million in any taxable year; or (5) the transaction involves a person that the taxpayer knows or has reason to know is in a Federal income tax position that differs from that of the taxpayer (such as a tax-exempt entity or foreign person), and the taxpayer knows or has reason to know that such difference has permitted the transaction to be structured to provide the taxpayer with a more favorable Federal income tax treatment.[118]

Under present law, there is no specific penalty for failing to disclose a reportable transaction; however, such a failure may jeopardize the taxpayer's ability to claim that any income tax understatement attributable to such undisclosed transaction is due to reasonable cause, and that the taxpayer acted in good faith.[119]

The Committee is aware that individuals and corporations are increasingly using sophisticated transactions to avoid or evade Federal income tax.[120] Such a phenomenon could pose a serious threat to the efficacy of the tax system because of both the potential loss of revenue and the potential threat to the integrity of the self-assessment system.

The Committee over two years ago began working on legislation to address this significant compliance problem. In addition, the Treasury Department, using the tools available, issued regulations requiring disclosure of certain transactions and requiring organizers and promoters of tax-engineered transactions to maintain customer lists and make these lists available to the IRS. Nevertheless, the Committee believed that additional legislation was needed to provide the Treasury Department with additional tools to assist its efforts to curtail abusive transactions. In that regard, the Committee issued for public comment three separate staff discussion drafts designed to address the tax shelter problem. The most recent

[117] Temp. Treas. Reg. sec. 1.6011–4T(b)(2) and (b)(4)(i).

[118] Temp. Treas. Reg. sec. 1.6011–4T(b)(3)(i)(A)–(E). In certain circumstances, a taxpayer can avoid disclosure with respect to the second category of reportable transactions. *See* Temp. Treas. Reg. sec. 1.6011–4T(b)(3)(ii)(A)–(E).

[119] Section 6664(c) provides that a taxpayer can avoid the imposition of a section 6662 accuracy-related penalty in cases where the taxpayer can demonstrate that there was reasonable cause for the underpayment and that the taxpayer acted in good faith.

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

draft (released in August 2001) focused on a regime that emphasized disclosure of tax shelter transactions.

On March 21, 2002, the Committee heard testimony from Treasury Department and IRS officials that only 272 transactions by 99 different taxpayers were disclosed under the present law for the 2001 tax-filing season. In connection with the hearing, the Treasury Department announced a new initiative (the "Treasury shelter initiative") that is designed to provide the Treasury Department and the Internal Revenue Service ("IRS") with the tools necessary to respond to abusive tax avoidance transactions.[121] The Treasury shelter initiative emphasizes combating abusive transactions by requiring increased disclosure of such transactions by all parties involved. To facilitate such disclosure, the Treasury shelter initiative proposes clearer definitions to identify transactions that must be disclosed, and stiffer penalties for failure to disclose such transactions. The Treasury shelter initiative provides for

> [A] series of clear, mutually reinforcing rules for disclosure, registration, and list maintenance. These rules will be easier for taxpayers and their advisors to apply, and harder for those who seek to avoid disclosure to manipulate. * * * The Treasury Department's proposals, for example, will broaden and align the rules and regulations for disclosure, registration, and list keeping under Sections 6011, 6111, and 6112 of the Code. * * * The Treasury Department's enforcement initiative will create a single, clear definition of a transaction that must be disclosed and registered, and for which lists must be maintained.

The Committee believes that the course of action outlined in the Treasury shelter initiative will bolster ongoing efforts to combat abusive tax avoidance transactions, and that encouraging greater disclosure of transactions with a potential for tax avoidance is beneficial to the tax system. Moreover, the Committee believes that a penalty for failing to make the required disclosures, when the imposition of such penalty is not dependent on the tax treatment of the underlying transaction ultimately being sustained, will provide an additional incentive for taxpayers to satisfy their reporting obligations under the new disclosure provisions.

EXPLANATION OF PROVISION

*In general*

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

[121] See generally, "The Treasury Department's Enforcement Proposals for Abusive Tax Avoidance Transactions," released on March 20, 2002, reprinted electronically at 2002 TNT 55–28 (March 21, 2002).

*Transactions to be disclosed*

The provision does not define the terms "listed transaction" [122] or "reportable transaction," nor does the provision explain the type of information that must be disclosed in order to avoid the imposition of a penalty. Rather, the provision authorizes the Treasury Department to define a "listed transaction" and a "reportable transaction" under section 6011. As part of the Treasury shelter initiative, the Committee expects the Treasury Department to issue new regulations under section 6011 that will provide taxpayers with a set of objective standards to be applied in determining whether a taxpayer must disclose information regarding a particular transaction. The Committee anticipates that the new regulations will define a reportable transaction to include (but not be limited to) transactions with any of the following characteristics: (1) a significant loss, (2) a brief holding period, (3) a transaction that is marketed under conditions of confidentiality, (4) a transaction that is subject to indemnification agreements, or (5) a certain amount of book-tax difference.[123]

*Disclosure requirements*

The Committee further expects that the new regulations will specify the manner in which a taxpayer must disclose reportable transactions. The Committee anticipates that the information required to be disclosed with respect to reportable transactions will be sufficiently detailed so as to provide the Treasury Department and IRS the ability to analyze all aspects of the transaction and determine an appropriate course of action (if any). To accomplish this objective, a taxpayer may be required to disclose the following information with respect to a reportable transaction: (1) a detailed description of all facts relevant to the expected tax treatment of the reportable transaction (such as the structure of the transaction and the principal elements of the transaction), (2) a description and schedule of the expected tax benefits for all tax years resulting from the reportable transaction (including any anticipated transactions as part of the overall strategy), (3) if applicable, the names and addresses of any party who promoted, solicited, or recommended the taxpayer's participation in the transaction and who had a financial interest (including the receipt of fees) in the taxpayer's decision to participate, and (4) other information that the Secretary may prescribe (e.g., the involvement of any accommodation party or any tax-indifferent party, the receipt of a tax opinion

[122] The provision states that, except as provided in regulations, a listed transaction means a reportable transaction, which is the same as, or similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011. The Committee anticipates that regulations under section 6011 will provide that a transaction is similar to a listed transaction if such transaction is expected to obtain the same or similar types of tax benefits and that is either factually similar or based on the same or similar tax strategy. The Secretary will have discretion to modify this definition as appropriate (as well as the definitions of reportable and listed transactions).

[123] The Treasury shelter initiative stated that a reportable transaction would be defined as any transaction with any of the following characteristics: (1) any transaction specifically identified by the IRS in published guidance as a tax avoidance transaction without regard to the size of the tax savings (i.e., a " listed transaction"), (2) certain loss transactions under section 165 in excess of $10 million for corporations, partnerships, and S corporations ($2 million for trusts and individuals), (3) any transaction resulting in a tax credit in excess of $250,000 if the taxpayer held the underlying asset for less than 45 days, (4) any book-tax difference of at least $10 million, subject to certain exceptions, and (5) any transaction marketed under conditions of confidentiality, if the transaction is expected to result in a reduction in taxable income of at least $250,000 ($500,000 in the case of a corporation).

with respect to the transaction, the amount of any fees paid to any promoter or advisor in connection with the transaction, any anticipated subsequent transactions or exit strategies).

The Committee intends that, in accordance with section 6065 (relating to verification of returns), the form the Secretary prescribes for taxpayer disclosure of reportable transactions will include a written declaration that the information is being provided under penalties of perjury. Moreover, the Committee intends that the verification under penalties of perjury also will apply to any large entity that discloses that it did not enter into any reportable transactions during the tax year covered by such declaration.

*Penalty rate*

The penalty for failing to disclose a reportable transaction is $50,000. The amount is increased to $100,000 if the failure is with respect to a listed transaction. For large entities and high net worth individuals, the penalty amount is doubled (i.e., $100,000 for a reportable transaction and $200,000 for a listed transaction). The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the penalty can be rescinded or abated only in exceptional circumstances.[124] All or part of the penalty may be rescinded only if: (1) the taxpayer on whom the penalty is imposed has a history of complying with the Federal tax laws, (2) it is shown that the violation is due to an unintentional mistake of fact, (3) imposing the penalty would be against equity and good conscience, and (4) rescinding the penalty would promote compliance with the tax laws and effective tax administration. The authority to rescind the penalty can only be exercised by the Commissioner personally or the head of the Office of Tax Shelter Analysis; this authority to rescind cannot otherwise be delegated by the Commissioner. Thus, the penalty cannot be rescinded by a revenue agent, an appeals officer, or other IRS personnel. The decision to rescind a penalty must be accompanied by a record describing the facts and reasons for the action and the amount rescinded. There will be no taxpayer right to appeal a refusal to rescind a penalty. The IRS also is required to submit an annual report to Congress summarizing the application of the disclosure penalties and providing a description of each penalty rescinded under this provision and the reasons for the rescission.

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

A public entity that is required to pay a penalty for failing to disclose a listed transaction (or is subject to an accuracy-related penalty for a nondisclosed listed transaction or a nondisclosed reportable transaction with a significant tax avoidance purpose [125]) must disclose the imposition of the penalty in reports to the Securities

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

[125] This category of transactions is described in greater detail below in connection with the provision modifying the accuracy-related penalty to tax shelters.

and Exchange Commission ("SEC") for such period as the Secretary shall specify. The provision applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear, and treats any failure to disclose a transaction in such reports as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the SEC once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).

As described above in connection with present law, current regulations under section 6011 require the disclosure of certain reportable transactions. Until such regulations are modified to reflect the new categories of reportable transactions, the penalty will apply to taxpayers who fail to timely disclose any reportable transaction under the definitions contained in the current regulations.

### EFFECTIVE DATE

The provision is effective for returns and statements the due date for which is after the date of enactment.

2. Modifications to the accuracy-related penalties for listed transactions and reportable transactions having a significant tax avoidance purpose (sec. 602 of the bill and new sec. 6662A and secs. 6662 and 6664 Of the Code)

### PRESENT LAW

The accuracy-related penalty applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of corporations), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.[126] The amount of any understatement generally is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.[127]

Special rules apply with respect to tax shelters.[128] For understatements by non-corporate taxpayers attributable to tax shelters, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for the position, the taxpayer reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters.

The understatement penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was "reasonable cause" for the underpayment and that the taxpayer acted in good faith.[129] The relevant regula-

[126] Sec. 6662.
[127] Sec. 6662(d)(2)(B).
[128] Sec. 6662(d)(2)(C).
[129] Sec. 6664(c).

tions provide that reasonable cause exists where the taxpayer "reasonably relies in good faith on an opinion based on a professional tax advisor's analysis of the pertinent facts and authorities [that] * * * unambiguously concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged" by the IRS.[130]

REASONS FOR CHANGE

The Committee understands that taxpayers are being advised not to disclose tax avoidance transactions on the grounds that any accuracy-related penalty that could result from an underpayment of tax on such a transaction can be avoided.[131] Because the Treasury shelter initiative emphasizes combating abusive tax avoidance transactions by requiring increased disclosure of such transactions by all parties involved, the Committee believes that taxpayers should be subject to a strict liability penalty on an understatement of tax that is attributable to non-disclosed listed transactions or non-disclosed reportable transactions that have a significant purpose of tax avoidance. Furthermore, in order to deter taxpayers from entering into tax avoidance transactions, the Committee believes that a more meaningful (but less stringent) accuracy-related penalty should apply to such transactions even when disclosed.

EXPLANATION OF PROVISION

*In general*

The provision modifies the present-law accuracy related penalty by replacing the rules applicable to tax shelters with a new accuracy-related penalty that applies to listed transactions and reportable transactions with a significant tax avoidance purpose (hereinafter referred to as a "reportable avoidance transaction").[132] The penalty rate and the taxpayer defenses available to avoid the penalty vary depending on the category of the transaction (i.e., listed or reportable avoidance transaction) and whether the transaction was adequately disclosed.

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

If the taxpayer does not adequately disclose the transaction, the strengthened reasonable cause exception is not available (i.e., a no-fault penalty applies), and the taxpayer is subject to an increased

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

[131] *See* "The Treasury Department's Enforcement Proposals for Abusive Tax Avoidance Transactions," at 12 (released on March 20, 2002), reprinted electronically at 2002 TNT 55–28 (March 21, 2002).

[132] The terms "reportable transaction" and "listed transaction" have the same meanings as previously described in connection with the penalty for failing to disclose a reportable transaction.

penalty rate. If the understatement is attributable to an undisclosed listed transaction, the penalty rate is increased to 30 percent of the understatement. For understatements attributable to an undisclosed reportable avoidance transaction, the penalty rate is 25 percent of the understatement.

*Determination of the understatement amount*

The penalty is applied to the amount of any understatement attributable to the listed or reportable avoidance transaction without regard to other items on the tax return. For purposes of this provision, the amount of the understatement is determined as the sum of (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return),[133] and (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item.

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

*Strengthened reasonable cause exception*

A penalty is not imposed under the provision with respect to any portion of an understatement if it is shown that there was reasonable cause for such portion and the taxpayer acted in good faith. Such a showing requires (1) adequate disclosure of the facts affecting the transaction in accordance with the regulations under section 6011,[134] (2) there is or was substantial authority for such treatment, and (3) the taxpayer reasonably believed that such treatment was more likely than not the proper treatment. For this purpose, a taxpayer will be treated as having a reasonable belief with respect to the tax treatment of an item only if such belief (1) is based on the facts and law that exist at the time the tax return (that includes the item) is filed, and (2) relates solely to the taxpayer's chances of success on the merits and does not take into account the possibility that (a) a return will not be audited, (b) the treatment will not be raised on audit, or (c) the treatment will be resolved through settlement if raised.

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

[133] For this purpose, any reduction in the excess of deductions allowed for the taxable year over gross income for such year, and any reduction in the amount of capital losses which would (without regard to section 1211) be allowed for such year, shall be treated as an increase in taxable income.

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

*Disqualified tax advisor*

A disqualified tax advisor is any material advisor [135] who (1) participates in the organization, management, promotion or sale of the transaction or is related (within the meaning of section 267 or 707) to any person who so participates, (2) is compensated by another material advisor with respect to the transaction, (3) has a fee arrangement with respect to the transaction that is contingent on all or part of the intended tax benefits from the transaction being sustained, or (4) as determined under regulations prescribed by the Secretary, has a continuing financial interest with respect to the transaction.[136]

*Organization, management, promotion or sale of a transaction*

The Committee intends that a material advisor be considered as participating in the "organization" of a transaction if the advisor performs acts relating to the development of the transaction. This may include, for example, preparing documents (1) establishing a structure used in connection with the transaction (such as a partnership agreement), (2) describing the transaction (such as an offering memorandum or other statement describing the transaction), or (3) relating to the registration of the transaction with any federal, state or local government body.[137] Participation in the "management" of a transaction means involvement in the decision-making process regarding any business activity with respect to the transaction. Participation in the "promotion or sale" of a transaction means involvement in the marketing or solicitation of the transaction to others. Thus, an advisor who provides information about the transaction to a potential participant is involved in the promotion or sale of a transaction, as is any advisor who recommends the transaction to a potential participant.

*Disqualified opinion*

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

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[135] The term "material advisor" (defined below in connection with the new information filing requirements for material advisors) means any person who provides any material aid, assistance, or advice with respect to organizing, promoting, selling, implementing, or carrying out any reportable transaction, and who derives gross income in excess of $50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons ($250,000 in any other case).

[136] This situation could arise, for example, when an advisor has an arrangement or understanding (oral or written) with an organizer, manager, or promoter of a reportable transaction that such party will recommend or refer potential participants to the advisor for an opinion regarding the tax treatment of the transaction.

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

*Coordination with other penalties*

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

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

EFFECTIVE DATE

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

3. Modifications to the substantial understatement penalty (sec. 603 of the bill and sec. 6662 of the Code)

PRESENT LAW

*Definition of substantial understatement*

An accuracy-related penalty equal to 20 percent applies to any substantial understatement of tax. A "substantial understatement" exists if the correct income tax liability for a taxable year exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of most corporations).[138]

*Reduction of understatement for certain positions*

For purposes of determining whether a substantial understatement penalty applies, the amount of any understatement generally is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.[139]

The Secretary is required to publish annually in the Federal Register a list of positions for which the Secretary believes there is not substantial authority and which affect a significant number of taxpayers.[140]

REASONS FOR CHANGE

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

The Committee believes that a higher compliance standard should be imposed on any taxpayer in order to reduce the amount of an understatement resulting from a transaction that the taxpayer did not adequately disclose. The Committee further believes that a taxpayer should not take a position on a tax return that could give rise to a substantial understatement penalty that the

[138] Sec. 6662(a) and (d)(1)(A).
[139] Sec. 6662(d)(2)(B).
[40] Sec. 6662(d)(2)(D)

taxpayer does not believe is more likely than not the correct tax treatment unless this information is disclosed to the IRS.

EXPLANATION OF PROVISION

*Definition of substantial understatement*

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

*Reduction of understatement for certain positions*

The provision elevates the standard that a taxpayer must satisfy in order to reduce the amount of an understatement for undisclosed items. With respect to the treatment of an item whose facts are not adequately disclosed, a resulting understatement is reduced only if the taxpayer had a reasonable belief that the tax treatment was more likely than not the proper treatment. The provision also authorizes (but does not require) the Secretary to publish a list of positions for which it believes there is not substantial authority or there is no reasonable belief that the tax treatment is more likely than not the proper treatment (without regard to whether such positions affect a significant number of taxpayers). The list shall be published in the Federal Register or the Internal Revenue Bulletin.

EFFECTIVE DATE

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

4. Tax shelter exception to confidentiality privileges relating to taxpayer communications (sec. 604 of the bill and sec. 7525 of the Code)

PRESENT LAW

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

REASONS FOR CHANGE

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

EXPLANATION OF PROVISION

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

EFFECTIVE DATE

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

5. Disclosure of reportable transactions by material advisors (secs. 611 and 612 of the bill and secs. 6111 and 6707 of the Code)

PRESENT LAW

*Registration of tax shelter arrangements*

An organizer of a tax shelter is required to register the shelter with the Secretary not later than the day on which the shelter is first offered for sale.[141] A "tax shelter" means any investment with respect to which the tax shelter ratio [142] for any investor as of the close of any of the first five years ending after the investment is offered for sale may be greater than two to one and which is: (1) required to be registered under Federal or State securities laws, (2) sold pursuant to an exemption from registration requiring the filing of a notice with a Federal or State securities agency, or (3) a substantial investment (greater than $250,000 and at least five investors).[143]

Other promoted arrangements are treated as tax shelters for purposes of the registration requirement if: (1) a significant purpose of the arrangement is the avoidance or evasion of Federal income tax by a corporate participant; (2) the arrangement is offered under conditions of confidentiality; and (3) the promoter may receive fees in excess of $100,000 in the aggregate.[144]

A transaction has a "significant purpose of avoiding or evading Federal income tax" if the transaction: (1) is the same as or substantially similar to a "listed transaction," [145] or (2) is structured to produce tax benefits that constitute an important part of the intended results of the arrangement and the promoter reasonably expects to present the arrangement to more than one taxpayer.[146] Certain exceptions are provided with respect to the second category of transactions.[147]

An arrangement is offered under conditions of confidentiality if: (1) an offeree has an understanding or agreement to limit the disclosure of the transaction or any significant tax features of the

[141] Sec. 6111(A)

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

[143] Sec. 6111(c).

[144] Sec. 6111(d).

[145] Temp. Treas. Reg. sec. 301.6111–2T(b)(2).

[146] Temp. Treas. Reg. sec. 301.6111–2T(b)(3).

[147] Temp. Treas. Reg. sec. 301.6111–2T(b)(4).

transaction; or (2) the promoter claims, knows, or has reason to know that a party other than the potential participant claims that the transaction (or any aspect of it) is proprietary to the promoter or any party other than the offeree, or is otherwise protected from disclosure or use.[148]

*Failure to register tax shelter*

The penalty for failing to timely register a tax shelter (or for filing false or incomplete information with respect to the tax shelter registration) generally is the greater of one percent of the aggregate amount invested in the shelter or $500.[149] However, if the tax shelter involves an arrangement offered to a corporation under conditions of confidentiality, the penalty is the greater of $10,000 or 50 percent of the fees payable to any promoter with respect to offerings prior to the date of late registration. Intentional disregard of the requirement to register increases the penalty to 75 percent of the applicable fees.

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

REASONS FOR CHANGE

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

The Committee believes that providing a single, clear definition regarding the types of transactions that must be disclosed by taxpayers and material advisors (as outlined in the Treasury shelter initiative), coupled with more meaningful penalties for failing to disclose such transactions, are necessary tools if the effort to curb the use of abusive tax avoidance transactions is to be effective.[150]

EXPLANATION OF PROVISION

*Disclosure of reportable transactions by material advisors*

The provision repeals the present law rules with respect to registration of tax shelters. Instead, the provision requires each material advisor with respect to any reportable transaction[151] to timely file an information return with the Secretary (in such form and manner as the Secretary may prescribe). The return must be filed on such date as specified by the Secretary.

[148] The regulations provide that the determination of whether an arrangement is offered under conditions of confidentiality is based on all the facts and circumstances surrounding the offer. If an offeree's disclosure of the structure or tax aspects of the transaction are limited in any way by an express or implied understanding or agreement with or for the benefit of a tax shelter promoter, an offer is considered made under conditions of confidentiality, whether or not such understanding or agreement is legally binding. Treas. Reg. sec. 301.6111–2T(c)(1).

[149] Sec. 6707.

[150] The Treasury Department's enforcement proposals for abusive tax avoidance transactions are described in greater detail above in connection with the penalty for failing to disclose reportable transactions (new sec. 6707A).

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

The information return will include (1) information identifying and describing the transaction, (2) information describing any potential tax benefits expected to result from the transaction, and (3) such other information as the Secretary may prescribe. It is expected that the Secretary may seek from the material advisor the same type of information that the Secretary may request from a taxpayer in connection with a reportable transaction.[152]

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

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

*Penalty for failing to furnish information regarding reportable transactions*

The provision repeals the present law penalty for failure to register tax shelters. Instead, the provision imposes a penalty on any material advisor who fails to file an information return with respect to any reportable transaction, or who files a false or incomplete information return with the Secretary with respect to a reportable transaction.[153] The amount of the penalty is $50,000. If the penalty is with respect to a listed transaction, the amount of the penalty is increased to the greater of (1) $200,000, or (2) 50 percent of the gross income of such person with respect to aid, assistance, or advice which is provided with respect to the reportable transaction before the date the information return that includes the transaction is filed. Intentional disregard by a material advisor of the requirement to disclose a reportable transaction increases the penalty to 75 percent of such gross income.

The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the penalty can be rescinded or abated only in exceptional circumstances.[154] All or part of the penalty may be rescinded only if: (1) the material advisor on whom the penalty is imposed has a history of complying with the Federal tax laws, (2) it is shown that the violation is due to an unintentional mistake of fact, (3) imposing the penalty would be against equity and good conscience, and (4) rescinding the penalty would promote compliance with the tax laws and effective tax administration. The authority to rescind the penalty can only be exercised by the Commissioner personally or the head of the Office of Tax Shel-

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

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

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

ter Analysis; this authority to rescind cannot otherwise be delegated by the Commissioner. Thus, the penalty cannot be rescinded by a revenue agent, an appeals officer, or other IRS personnel. The decision to rescind a penalty must be accompanied by a record describing the facts and reasons for the action and the amount rescinded. There will be no right to appeal a refusal to rescind a penalty. The IRS also is required to submit an annual report to Congress summarizing the application of the disclosure penalties and providing a description of each penalty rescinded under this provision and the reasons for the rescission.

EFFECTIVE DATE

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

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

### 6. Investor lists and applicable penalties (secs. 611 and 613 of the bill and secs. 6112 and 6708 of the Code)

PRESENT LAW

*Investor lists*

A promoter must maintain (for a period of seven years) a list identifying each person who was sold an interest in any tax shelter with respect to which registration was required under section 6111 (even though the particular party may not have been subject to confidentiality restrictions).[155] Regulations under section 6112 provide that, in addition to the name, tax shelter identification number and other identifying information the promoter must include detailed information about the tax shelter (including details of the shelter and the expected tax benefits, as well as copies of any additional written material given to any participant or advisor).[156] A limited exception is provided for certain shelters if the total fees are less than $25,000 or if the expected reduction in tax liabilities for any single year is less than $1 million for corporations or $250,000 for non-corporate taxpayers.[157] The Secretary is required to prescribe regulations which provide that, in cases in which 2 or more persons are required to maintain the same list, only one person would be required to maintain the list.[158]

*Penalties for failing to maintain investor lists*

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

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[155] Sec. 6112.
[156] *See* Temp. Treas. Reg. sec. 301.6112–1T Q&A 17.
[157] *See* Temp. Treas. Reg. sec. 301–6112–1T Q&A 8.
[158] Sec. 6112(c)(2).

## REASONS FOR CHANGE

The Committee has been advised that the present-law penalties for failure to maintain customer lists are not meaningful and that promoters often have refused to provide requested information to the IRS. The Committee believes that requiring material advisors to maintain a list of advisees with respect to each reportable transaction, coupled with more meaningful penalties for failing to maintain an investor list, are important tools in the ongoing efforts to curb the use of abusive tax avoidance transactions. Furthermore, these provisions are consistent with the course of action outlined in the Treasury shelter initiative.[159]

## EXPLANATION OF PROVISION

*Investor lists*

Each material advisor[160] that is required to file an information return with respect to a reportable transaction[161] is required to maintain a list that (1) identifies each person with respect to whom the advisor acted as a material advisor with respect to the reportable transaction, and (2) contains other information as may be required by the Secretary. In addition, the provision authorizes (but does not require) the Secretary to prescribe regulations which provide that, in cases in which 2 or more persons are required to maintain the same list, only one person would be required to maintain the list.

*Penalty for failing to maintain investor lists*

The provision modifies the penalty for failing to maintain the required list by making it a time-sensitive penalty. Thus, a material advisor who is required to maintain an investor list and who fails to make the list available upon request by the Secretary within 20 business days after the request will be subject to a $10,000 per day penalty. The penalty applies to a person who fails to maintain a list, maintains an incomplete list, or has in fact maintained a list but does not make the list available to the Secretary. The penalty can be waived if the failure to make the list available is due to reasonable cause.[162]

## EFFECTIVE DATE

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

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

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[159] The Treasury Department's enforcement proposals for abusive tax avoidance transactions are described in greater detail above in connection with the penalty for failing to disclose reportable transactions (new sec. 6707A).

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

[161] The term "reportable transaction" has the same meaning as previously described in connection with the taxpayer-related provisions.

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

### 7. Actions to enjoin conduct with respect to tax shelters (sec. 614 of the bill and sec. 7408 of the Code)

PRESENT LAW

The Code authorizes civil action to enjoin any person from promoting abusive tax shelters or aiding or abetting the understatement of tax liability.[163]

REASONS FOR CHANGE

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

EXPLANATION OF PROVISION

The bill expands this rule so that injunctions may also be sought with respect to the requirements relating to the reporting of tax shelters[164] and the keeping of lists of investors by material advisors.[165] Thus, under the provision, an injunction may be sought against a material advisor to enjoin the advisor from (1) failing to file an information return with respect to a reportable transaction, or (2) failing to maintain, or to timely furnish upon written request by the Secretary, a list of investors with respect to each reportable transaction.

EFFECTIVE DATE

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

### 8. Understatement of taxpayer's liability by income tax return preparer (sec. 621 of the bill and sec. 6694 of the Code)

PRESENT LAW

An income tax return preparer who prepares a return with respect to which there is an understatement of tax that is due to a position for which there was not a realistic possibility of being sustained on its merits and the position was not disclosed (or was frivolous) is liable for a penalty of $250, provided that the preparer knew or reasonably should have known of the position. An income tax return preparer who prepares a return and engages in specified willful or reckless conduct with respect to preparing such a return is liable for a penalty of $1,000.

REASONS FOR CHANGE

The Committee believes that the standards of conduct applicable to income tax return preparers should be the same as the standards applicable to taxpayers. Accordingly, the minimum standard for each undisclosed position on a tax return would be that the preparer must reasonably believe that the tax treatment is more likely than not the proper tax treatment. The Committee believes that

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[163] Sec. 7408.
[164] Sec. 6707, as amended by other provisions of this bill.
[165] Sec. 6708, as amended by other provisions of this bill.

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

EXPLANATION OF PROVISION

The bill alters the standards of conduct that must be met to avoid imposition of the first penalty. The bill replaces the realistic possibility standard with a requirement that there be a reasonable belief that the tax treatment of the position was more likely than not the proper treatment. The bill also replaces the not frivolous standard with the requirement that there be a reasonable basis for the tax treatment of the position.

In addition, the bill increases the amount of these penalties. The penalty relating to not having a reasonable belief that the tax treatment was more likely than not the proper tax treatment is increased from $250 to $1,000. The penalty relating to willful or reckless conduct is increased from $1,000 to $5,000.

EFFECTIVE DATE

The provision is effective for documents prepared after the date of enactment.

9. Penalty on failure to report interests in foreign financial accounts (sec. 622 of the bill and sec. 5321 of Title 31, United States Code)

PRESENT LAW

The Secretary of the Treasury must require citizens, residents, or persons doing business in the United States to keep records and file reports when that person makes a transaction or maintains an account with a foreign financial entity.[166] In general, individuals must fulfill this requirement by answering questions regarding foreign accounts or foreign trusts that are contained in Part III of Schedule B of the IRS Form 1040. Taxpayers who answer “yes” in response to the question regarding foreign accounts must then file Treasury Department Form TD F 90–22.1. This form must be filed with the Department of the Treasury, and not as part of the tax return that is filed with the IRS.

The Secretary of the Treasury may impose a civil penalty on any person who willfully violates this reporting requirement. The civil penalty is the amount of the transaction or the value of the account, up to a maximum of $100,000; the minimum amount of the penalty is $25,000.[167] In addition, any person who willfully violates this reporting requirement is subject to a criminal penalty. The

[166] 31 U.S.C. 5314.
[167] 31 U.S.C. 5321(a)(5).

criminal penalty is a fine of not more than $250,000 or imprisonment for not more than five years (or both); if the violation is part of a pattern of illegal activity, the maximum amount of the fine is increased to $500,000 and the maximum length of imprisonment is increased to 10 years.[168]

On April 26, 2002, the Secretary of the Treasury submitted to the Congress a report on these reporting requirements.[169] This report, which was statutorily required,[170] studies methods for improving compliance with these reporting requirements. It makes several administrative recommendations, but no legislative recommendations. A further report is required to be submitted by the Secretary of the Treasury to the Congress by October 26, 2002.

REASONS FOR CHANGE

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

EXPLANATION OF PROVISION

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

EFFECTIVE DATE

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

### 10. Frivolous tax returns and submissions (sec. 623 of the bill and sec. 6702 of the Code)

PRESENT LAW

The Code provides that an individual who files a frivolous income tax return is subject to a penalty of $500 imposed by the IRS (sec. 6702). The Code also permits the Tax Court[171] to impose a penalty of up to $25,000 if a taxpayer has instituted or maintained pro-

[168] 31 U.S.C. 5322.

[169] A Report to Congress in Accordance with Sec. 361(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to itercept and Obstruct Terrorism Act of 2001, April 26, 2002.

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

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

ceedings primarily for delay or if the taxpayer's position in the proceeding is frivolous or groundless (sec. 6673(a)).

### REASONS FOR CHANGE

The IRS has been faced with a significant number of tax filers who are filing returns based on frivolous arguments or who are seeking to hinder tax administration by filing returns that are patently incorrect. In addition, taxpayers are using existing procedures for collection due process hearings, offers-in-compromise, installment agreements, and taxpayer assistance orders to impede or delay tax administration by raising frivolous arguments. These procedures were intended to provide assistance to taxpayers genuinely seeking to resolve legitimate disputes with the IRS, and the use of these procedures for impeding or delaying tax administration diverts scarce IRS resources away from resolving genuine disputes. Allowing the IRS to assert more substantial penalties for frivolous submissions and to dismiss frivolous requests without the need to follow otherwise mandated procedures will deter frivolous taxpayer behavior and enable the IRS to use its resources to better assist taxpayers in resolving genuine disputes.

### EXPLANATION OF PROVISION

The bill modifies the IRS-imposed penalty by increasing the amount of the penalty to up to $5,000 and by applying it to all taxpayers and to all types of Federal taxes.

The provision also modifies present law with respect to certain submissions that raise frivolous arguments or that are intended to delay or impede tax administration. The submissions to which this provision applies are requests for a collection due process hearing, installment agreements, offers-in-compromise, and taxpayer assistance orders. First, the provision permits the IRS to dismiss such requests. Second, the provision permits the IRS to impose a penalty of up to $5,000 for such requests, unless the taxpayer withdraws the request after being given an opportunity to do so.

The provision requires the IRS to publish a list of positions, arguments, requests, and proposals determined to be frivolous for purposes of these provisions.

### EFFECTIVE DATE

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

## 11. Regulation of individuals practicing before the Department of the Treasury (sec. 624 of the bill and sec. 330 of Title 31, United States Code)

### PRESENT LAW

The Secretary of the Treasury is authorized to regulate the practice of representatives of persons before the Department of the Treasury.[172] The Secretary is also authorized to suspend or disbar from practice before the Department a representative who is incompetent, who is disreputable, who violates the rules regulating prac-

[172] 31 U.S.C. 330.

tice before the Department, or who (with intent to defraud) willfully and knowingly misleads or threatens the person being represented (or a person who may be represented). The rules promulgated by the Secretary pursuant to this provision are contained in Circular 230.

REASONS FOR CHANGE

The Committee believes that it is critical that the Secretary have the authority to censure tax advisors as well as to impose monetary sanctions against tax advisors because of the important role of tax advisors in our tax system. Use of these sanctions is expected to curb the participation of tax advisors in both tax shelter activity and any other activity that is contrary to Circular 230 standards.

EXPLANATION OF PROVISION

The bill makes two modifications to expand the sanctions that the Secretary may impose pursuant to these statutory provisions. First, the bill expressly permits censure as a sanction.

Second, the bill permits the imposition of a monetary penalty as a sanction. If the representative is acting on behalf of an employer or other entity, the Secretary may impose a monetary penalty on the employer or other entity if it knew, or reasonably should have known, of the conduct. This monetary penalty on the employer or other entity may be imposed in addition to any monetary penalty imposed directly on the representative. These monetary penalties are not to exceed the gross income derived (or to be derived) from the conduct giving rise to the penalty. These monetary penalties may be in addition to, or in lieu of, any suspension, disbarment, or censure.

The bill also confirms the present-law authority of the Secretary to impose standards applicable to written advice with respect to an entity, plan, or arrangement that is of a type that the Secretary determines as having a potential for tax avoidance or evasion.

EFFECTIVE DATE

The modifications to expand the sanctions that the Secretary may impose are effective for actions taken after the date of enactment.

### 12. Penalties on promoters of tax shelters (sec. 625 of the bill and sec. 6700 of the Code)

PRESENT LAW

A penalty is imposed on any person who organizes, assists in the organization of, or participates in the sale of any interest in, a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if in connection with such activity the person makes or furnishes a qualifying false or fraudulent statement or a gross valuation overstatement.[173] A qualified false or fraudulent statement is any statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement

[173] Sec. 6700.

which the person knows or has reason to know is false or fraudulent as to any material matter. A "gross valuation overstatement" means any statement as to the value of any property or services if the stated value exceeds 200 percent of the correct valuation, and the value is directly related to the amount of any allowable income tax deduction or credit.

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

#### REASONS FOR CHANGE

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

#### EXPLANATION OF PROVISION

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

#### EFFECTIVE DATE

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

### 13. Affirmation of consolidated return regulation authority (sec. 631 of the bill and sec. 1502 of the Code)

#### PRESENT LAW

An affiliated group of corporations may elect to file a consolidated return in lieu of separate returns. A condition of electing to file a consolidated return is that all corporations that are members of the consolidated group must consent to all the consolidated return regulations prescribed under section 1502 prior to the last day prescribed by law for filing such return.[174]

Section 1502 states:

> The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such

[174] Sec. 1501.

liability, and in order to prevent the avoidance of such tax liability.[175]

Under this authority, the Treasury Department has issued extensive consolidated return regulations.[176]

In the recent case of Rite Aid Corp. v. United States,[177] the Federal Circuit Court of Appeals addressed the application of a particular provision of certain consolidated return loss disallowance regulations, and concluded that the provision was invalid.[178] The particular provision, known as the "duplicated loss" provision,[179] would have denied a loss on the sale of stock of a subsidiary by a parent corporation that had filed a consolidated return with the subsidiary, to the extent the subsidiary corporation had assets that had a built-in loss, or had a net operating loss, that could be recognized or used later.[180]

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[175] Sec. 1502.

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

[177] 255 F.3d 1357 (Fed. Cir. 2001), reh'g denied, 2001 U.S. App. LEXIS 23207 (Fed. Cir. Oct. 3, 2001).

[178] Prior to this decision, there had been a few instances involving prior laws in which certain consolidated return regulations were held to be invalid. *See,* e.g., American Standard, Inc. v. United States, 602 F.2d 256 (Ct. Cl. 1979), discussed in the text infra. see also Union Carbide Corp. v. United States, 612 F.2d 558 (Ct. Cl. 1979), and Allied Corporation v. United States, 685 F. 2d 396 (Ct. Cl. 1982), all three cases involving the allocation of income and loss within a consolidated group for purposes of computation of a deduction allowed under prior law by the Code for Western Hemisphere Trading Corporations. . *See also* Joseph Weidenhoff v. Commissioner, 32 T.C. 1222, 1242–1244 (1959), involving the application of certain regulations to the excess profits tax credit allowed under prior law, and concluding that the Commissioner had applied a particular regulation in an arbitrary manner inconsistent with the wording of the regulation and inconsistent with even a consolidated group computation. Cf. Kanawha Gas & Utilities Co. v. Commissioner, 214 F.2d 685 (1954), concluding that the substance of a transaction was an acquisition of assets rather than stock. Thus, a regulation governing basis of the assets of consolidated subsidiaries did not apply to the case. See also General Machinery Corporation v. Commissioner, 33 B.T.A. 1215 (1936); Lefcourt Realty Corporation, 31 B.T.A. 978 (1935); Helvering v. Morgans, Inc., 293 U.S. 121 (1934), interpreting the term "taxable year."

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

[180] Treasury Regulation section 1.1502–20, generally imposing certain "loss disallowance" rules on the disposition of subsidiary stock, contained other limitations besides the "duplicated loss" rule that could limit the loss available to the group on a disposition of a subsidiary's stock. Treasury Regulation section 1.1502–20 as a whole was promulgated in connection with regulations issued under section 337(d), principally in connection with the so-called General Utilities repeal of 1986 (referring to the case of General Utilities & Operating Company v. Helvering, 296 U.S. 200 (1935)). Such repeal generally required a liquidating corporation, or a corporation acquired in a stock acquisition treated as a sale of assets, to pay corporate level tax on the excess of the value of its assets over the basis. Treasury regulation section 1.1502–20 principally reflected an attempt to prevent corporations filing consolidated returns from offsetting income with a loss on the sale of subsidiary stock. Such a loss could result from the unique upward adjustment of a subsidiary's stock basis required under the consolidated return regulations for subsidiary income earned in consolidation, an adjustment intended to prevent taxation of both the subsidiary and the parent on the same income or gain. As one example, absent a denial of certain losses on a sale of subsidiary stock, a consolidated group could obtain a loss deduction with respect to subsidiary stock, the basis of which originally reflected the subsidiary's value at the time of the purchase of the stock, and that had then been adjusted upward on recognition of any built-in income or gain of the subsidiary reflected in that value. The regulations also contained the duplicated loss factor addressed by the court in Rite Aid. The preamble to the regulations stated: "it is not administratively feasible to differentiate between loss attributable to built-in gain and duplicated loss." T.D. 8364, 1991–2 C.B. 43, 46 (Sept. 13, 1991). The government also argued in the Rite Aid case that duplicated loss was a separate concern of the regulations. 255 F.3d at 1360.

The Federal Circuit Court opinion contained language discussing the fact that the regulation produced a result different than the result that would have obtained if the corporations had filed separate returns rather than consolidated returns.[181]

The Federal Circuit Court opinion cited a 1928 Senate Finance Committee Report to legislation that authorized consolidated return regulations, which stated that "many difficult and complicated problems, * * * have arisen in the administration of the provisions permitting the filing of consolidated returns" and that the committee "found it necessary to delegate power to the commissioner to prescribe regulations legislative in character covering them."[182] The Court's opinion also cited a previous decision of the Court of Claims for the proposition, interpreting this legislative history, that section 1502 grants the Secretary "the power to conform the applicable income tax law of the Code to the special, myriad problems resulting from the filing of consolidated income tax returns;" but that section 1502 "does not authorize the Secretary to choose a method that imposes a tax on income that would not otherwise be taxed."[183]

The Federal Circuit Court construed these authorities and applied them to invalidate Treas. Reg. Sec. 1.1502–20(c)(1)(iii), stating that:

> The loss realized on the sale of a former subsidiary's assets after the consolidated group sells the subsidiary's stock is not a problem resulting from the filing of consolidated income tax returns. The scenario also arises where a corporate shareholder sells the stock of a non-consolidated subsidiary. The corporate shareholder could realize a loss under I.R.C. sec. 1001, and deduct the loss under I.R.C. sec. 165. The subsidiary could then deduct any losses from a later sale of assets. The duplicated loss factor, therefore, addresses a situation that arises from the sale of stock regardless of whether corporations file separate or consolidated returns. With I.R.C. secs. 382 and 383,

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[181] For example, the court stated: "The duplicated loss factor . . . addresses a situation that arises from the sale of stock regardless of whether corporations file separate or consolidated returns. With I.R.C. secs. 382 and 383, Congress has addressed this situation by limiting the subsidiary's potential future deduction, not the parent's loss on the sale of stock under I.R.C. sec. 165." 255 F.3d 1357, 1360 (Fed. Cir. 2001).

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

[183] American Standard, Inc. v. United States, 602 F.2d 256, 261 (Ct. Cl. 1979). That case did not involve the question of separate returns as compared to a single return approach. It involved the computation of a Western Hemisphere Trade Corporation ("WHTC") deduction under prior law (which deduction would have been computed as a percentage of each WHTC's taxable income if the corporations had filed separate returns), in a case where a consolidated group included several WHTCs as well as other corporations. The question was how to apportion income and losses of the admittedly consolidated WHTCs and how to combine that computation with the rest of the group's consolidated income or losses. The court noted that the new, changed regulations approach varied from the approach taken to a similar problem involving public utilities within a group and previously allowed for WHTCs. The court objected that the allocation method adopted by the regulation allowed non-WHTC losses to reduce WHTC income. However, the court did not disallow a method that would net WHTC income of one WHTC with losses of another WHTC, a result that would not have occurred under separate returns. Nor did the court expressly disallow a different fractional method that would net both income and losses of the WHTCs with those of other corporations in the consolidated group. The court also found that the regulation had been adopted without proper notice.

> Congress has addressed this situation by limiting the subsidiary's potential future deduction, not the parent's loss on the sale of stock under I.R.C. sec. 165.[184]

The Treasury Department has announced that it will not continue to litigate the validity of the duplicated loss provision of the regulations, and has issued interim regulations that permit taxpayers for all years to elect a different treatment, though they may apply the provision for the past if they wish.[185]

REASONS FOR CHANGE

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

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

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

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

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

EXPLANATION OF PROVISION

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

Thus, under the statutory authority of section 1502, the Treasury Department is authorized to issue consolidated return regulations utilizing either a single taxpayer or separate taxpayer approach or a combination of the two approaches, as Treasury deems necessary in order that the tax liability of any affiliated group of corporations making a consolidated return, and of each corporation in the group, both during and after the period of affiliation, may be determined

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

[185] *See* Temp. Reg. 1.1502–20T(i)(2). The Treasury Department has also indicated its intention to continue to study all the issues that the original loss disallowance regulations addressed (including issues of furthering single entity principles) and possibly issue different regulations (not including the particular approach of Treas. Reg. Sec. 1.1502–20(c)(1)(iii)) on the issues in the future. See Notice 2002–11, 2002–7 I.R.B. 526 (Feb. 19, 2002); T.D. 8984, 67 F.R. 11034 (March 12, 2002); REG–102740–02, 67 F.R. 11070 (March 12, 2002); *see also* Notice 2002–18, 2002–12 I.R.B. 644 (March 25, 2002).

and adjusted in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such liability.

Rite Aid is thus overruled to the extent it suggests that there is not a problem that can be addressed in consolidated return regulations if application of a particular Code provision on a separate taxpayer basis would produce a result different from single taxpayer principles that may be used for consolidation.

The provision nevertheless allows the result of the Rite Aid case to stand with respect to the type of factual situation presented in the case. That is, the legislation provides for the override of the regulatory provision that took the approach of denying a loss on a deconsolidating disposition of stock of a consolidated subsidiary [186] to the extent the subsidiary had net operating losses or built in losses that could be used later outside the group.[187]

Retaining the result in the Rite Aid case with respect to the particular regulation section 1.1502–20(c)(1)(iii) as applied to the factual situation of the case does not in any way prevent or invalidate the various approaches Treasury has announced it will apply or that it intends to consider in lieu of the approach of that regulation, including, for example, the denial of a loss on a stock sale if inside losses of a subsidiary may also be used by the consolidated group, and the possible requirement that inside attributes be adjusted when a subsidiary leaves a group.[188]

EFFECTIVE DATE

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

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

## B. Tax Treatment of Inversion Transactions

(Sec. 641 of the bill and new sec. 7874 of the Code)

PRESENT LAW

*Determination of corporate residence*

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

[186] Treas. Reg. Sec. 1.1502–20(c)(1)(iii).

[187] The Committee does not intend to overrule the current Treasury Department regulations, which allow taxpayers for the past to follow Treasury Regulations Section 1.1502–20(c)(1)(iii), if they choose to do so. Temp. Reg. Sec. 1.1502–20T(i)(2).

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

tion's management activities, employees, business assets, operations, or revenue sources, the exchanges on which the corporation's stock is traded, or the residence of the corporation's managers and shareholders.

*U.S. taxation of domestic corporations*

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

Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income is generally deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F (sections 951–964) and the passive foreign investment company rules (sections 1291–1298). A foreign tax credit is generally available to offset, in whole or in part, the U.S. tax owed on this foreign-source income, whether repatriated as an actual dividend or included under one of the anti-deferral regimes.

*U.S. taxation of foreign corporations*

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

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

*U.S. tax treatment of inversion transactions*

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

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

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

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

REASONS FOR CHANGE

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

EXPLANATION OF PROVISION

*In general*

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

*Transactions involving at least 80 percent identity of stock ownership*

The first type of inversion is a transaction in which, pursuant to a plan or a series of related transactions: (1) a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity; (2) the former shareholders of the U.S. corporation hold (by reason of holding stock in the U.S. corporation) 80 percent or more (by vote or value) of the stock of the foreign-incorporated entity after the transaction; and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50 percent ownership (i.e., the "expanded affiliated group"), does not have substantial business activities in the entity's country of incorporation, compared to the total worldwide business activities of the expanded affiliated group. The provision denies the intended tax benefits of this type of inversion by deeming the top-tier foreign corporation to be a domestic corporation for all purposes of the Code.[189]

In determining whether a transaction would meet the definition of an inversion under the provision, stock held by members of the expanded affiliated group that includes the foreign incorporated entity is disregarded. For example, if the former top-tier U.S. corporation receives stock of the foreign incorporated entity (e.g., so-called "hook" stock), the stock would not be considered in determining whether the transaction meets the definition. Similarly, if a U.S. parent corporation converts an existing wholly owned U.S. subsidiary into a new wholly owned controlled foreign corporation, the stock of the new foreign corporation would be disregarded. Stock sold in a public offering related to the transaction also is disregarded for these purposes.

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

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

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

With respect to "toll charges," any applicable corporate-level income or gain required to be recognized under sections 304, 311(b), 367, 1001, 1248, or any other provision with respect to the transfer of controlled foreign corporation stock or other assets by a U.S. corporation as part of the inversion transaction or after such transaction to a related foreign person is taxable, without offset by any tax attributes (e.g., net operating losses or foreign tax credits). To

[189] Since the top-tier foreign corporation would be treated for all purposes of the Code as domestic, the shareholder-level "toll charge" of sec. 367(a) would not apply to these inversion transactions.

the extent provided in regulations, this rule will not apply to certain transfers of inventory and similar transactions conducted in the ordinary course of the taxpayer's business.

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

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

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

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

The "earnings stripping" rules of section 163(j), which deny or defer deductions for certain interest paid to foreign related parties, are strengthened for inverted corporations. With respect to such corporations, the provision eliminates the debt-equity threshold generally applicable under section 163(j) and reduces the 50-percent thresholds for "excess interest expense" and "excess limitation" to 25 percent. In cases in which a U.S. corporate group acquires subsidiaries or other assets from an unrelated inverted corporate group, the provisions described above generally do not apply to the acquiring U.S. corporate group or its related parties (including the newly acquired subsidiaries or assets) by reason of acquiring the subsidiaries or assets that were connected with the inversion transaction. The Treasury Secretary is given authority to issue regulations appropriate to carry out the purposes of this provision and to prevent its abuse.

*Partnership transactions*

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

EFFECTIVE DATE

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

## C. Reinsurance Agreements

(Sec. 651 of the bill and sec. 845 of the Code)

PRESENT LAW

In the case of a reinsurance agreement between two or more related persons, present law provides the Treasury Secretary with authority to allocate among the parties or recharacterize income (whether investment income, premium or otherwise), deductions, assets, reserves, credits and any other items related to the reinsurance agreement, or make any other adjustment, in order to reflect the proper source and character of the items for each party.[190] For this purpose, related persons are defined as in section 482. Thus, persons are related if they are organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) that are owned or controlled directly or indirectly by the same interests. The provision may apply to a contract even if one of the related parties is not a domestic company.[191] In addition, the provision also permits such allocation, recharacterization, or other adjustments in a case in which one of the parties to a reinsurance agreement is, with respect to any contract covered by the agreement, in effect an agent

[190] Sec. 845(a).
[191] See S. Rep. No. 97–494, "Tax Equity and Fiscal Responsibility Act of 1982," July 12, 1982, 337 (describing provisions relating to the repeal of modified coinsurance provisions).

of another party to the agreement, or a conduit between related persons.

REASONS FOR CHANGE

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

EXPLANATION OF PROVISION

The provision clarifies the rules of section 845, relating to authority for the Treasury Secretary to allocate items among the parties to a reinsurance agreement, recharacterize items, or make any other adjustment, in order to reflect the proper source and character of the items for each party. The provision authorizes such allocation, recharacterization, or other adjustment, in order to reflect the proper source, character or amount of the item. It is intended that this authority [192] be exercised in a manner similar to the authority under section 482 for the Treasury Secretary to make adjustments between related parties. It is intended that this authority be applied in situations in which the related persons (or agents or conduits) are engaged in cross- border transactions that require allocation, recharacterization, or other adjustments in order to reflect the proper source, character or amount of the item or items. No inference is intended that present law does not provide this authority with respect to reinsurance agreements.

The Committee notes that no regulations have been issued under section 845(a). The Committee expects that the Treasury Department shall issue regulations under section 845(a) to address effectively the allocation of income (whether investment income, premium or otherwise) and other items, the recharacterization of such items, or any other adjustment necessary to reflect the proper amount, source or character of the item.

EFFECTIVE DATE

The provision is effective for any risk reinsured after April 11, 2002.

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

## D. Extension of IRS User Fees

(Sec. 661 of the bill and new sec. 7527 of the Code)

### PRESENT LAW

The IRS provides written responses to questions of individuals, corporations, and organizations relating to their tax status or the effects of particular transactions for tax purposes. The IRS generally charges a fee for requests for a letter ruling, determination letter, opinion letter, or other similar ruling or determination. Public Law 104–117 [193] extended the statutory authorization for these user fees [194] through September 30, 2003.

### REASONS FOR CHANGE

The Committee believes that it is appropriate to extend the statutory authorization for these user fees.

### EXPLANATION OF PROVISION

The bill extends the statutory authorization for these user fees through June 30, 2008. The bill also moves the statutory authorization for these fees into the Internal Revenue Code.

### EFFECTIVE DATE

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

## E. Extension of Customs Service User Fees

(Sec. 671 of the bill)

### PRESENT LAW

Section 13031(j)(3) of the Consolidated Omnibus Budget Reconciliation Act of 1985 (19 U.S.C. 58c(j)(3)) authorizes the temporary imposition and collection of custom user fees in connection with services provided by the United States Customs Service. The authorization is scheduled to expire on September 30, 2003.

### REASONS FOR CHANGE

The Committee believes that it is appropriate to extend the statutory authorization for these user fees.

### EXPLANATION OF PROVISION

The provision extends the authority to impose and collect custom user fees through June 30, 2008, provided, however, that any revenue generated from such custom user fees may be used only to fund the operations of the United States Customs Service.

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[193] An Act to provide that members of the Armed Forces performing services for the peacekeeping efforts in Bosnia and Herzegovina, Croatia, and Macedonia shall be entitled to tax benefits in the same manner as if such services were performed in a combat zone, and for other purposes (March 20, 1996).

[194] These user fees were originally enacted in section 10511 of the Revenue Act of 1987 (Public Law 100–203, December 22, 1987).

#### EFFECTIVE DATE

The provision is effective on the date of enactment.

## III. BUDGET EFFECTS OF THE BILL

### A. Committee Estimates

In compliance with paragraph 11(a) of rule XXVI of the Standing Rules of the Senate, the following statement is made concerning the estimated budget effects of the committee amendment to the bill as reported.

**ESTIMATED REVENUE EFFECTS OF H.R. 7,**
**THE "CARE ACT OF 2002,"**
**AS REPORTED BY THE COMMITTEE ON FINANCE**

**Fiscal Years 2002 - 2012**

*[Millions of Dollars]*

| Provision | Effective | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2002-07 | 2002-12 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Charitable and Tax Exempt Organization Provisions, SSBG Funding, and IDAs** | | | | | | | | | | | | | | |
| **Charitable Giving Incentive Provisions** | | | | | | | | | | | | | | |
| 1. Provide charitable contribution deduction for non-itemizers with cash contributions in excess of $250 for individuals and $500 for joint returns; cap on deduction of $250 for individuals and $500 for joint returns | tyba 12/31/01 & tybb 1/1/04 | -185 | -1,247 | -1,131 | --- | --- | --- | --- | --- | --- | --- | --- | -2,563 | -2,563 |
| 2. Tax-free distributions from IRAs for charitable purposes - taxpayer must have attained age 70-1/2 for contributions made directly to a charitable organization and age 59-1/2 for contributions to a split-interest entity | tyba 12/31/02 | --- | -115 | -250 | -269 | -272 | -269 | -268 | -269 | -281 | -383 | -505 | -1,175 | -2,880 |
| 3. Extend present-law section 170(e)(3) deduction for food inventory to all businesses and provide special basis rule for certain taxpayers | tyba 12/31/02 | --- | -29 | -55 | -61 | -66 | -69 | -71 | -74 | -77 | -80 | -83 | -280 | -665 |
| 4. Enhanced charitable deduction for contributions of book inventories, with special fair market value rule | tyba 12/31/02 | --- | -16 | -26 | -29 | -32 | -36 | -40 | -44 | -48 | -52 | -56 | -139 | -379 |
| 5. Expand charitable contribution allowed for scientific property used for research and for computer technology and equipment | tyba 12/31/01 | -1 | -1 | -1 | -1 | -1 | -1 | -1 | -1 | -1 | -1 | -1 | -5 | -11 |
| 6. Encourage contributions of capital gain real property made for conservation purposes | cmi tyba 12/31/02 | --- | -4 | -6 | -10 | -14 | -18 | -26 | -36 | -46 | -57 | -69 | -52 | -285 |
| 7. 25% capital gain exclusion for sales or exchanges of land or interest in land or water to eligible entities for conservation purposes | sma 12/31/03 | --- | -2 | -18 | -50 | -76 | -80 | -85 | -89 | -94 | -99 | -105 | -226 | -698 |
| 8. Exclusion for government payments under Partners for Fish and Wildlife Program | tyba 12/31/02 | --- | -1 | -2 | -2 | -3 | -3 | -3 | -3 | -3 | -3 | -3 | -9 | -23 |
| 9. Adjustment to basis of S corporation stock for certain charitable contributions | cmi tyba 12/31/02 | --- | -12 | -26 | -30 | -33 | -36 | -40 | -45 | -49 | -55 | -62 | -137 | -388 |
| 10. Enhanced deduction for charitable contribution of literary, musical, artistic, and scholarly compositions | cmi tyba 12/31/02 | --- | -2 | -4 | -4 | -5 | -5 | -6 | -6 | -6 | -7 | -7 | -20 | -52 |
| **Total of Charitable Giving Incentive Provisions** | | **-186** | **-1,429** | **-1,519** | **-456** | **-502** | **-517** | **-540** | **-567** | **-605** | **-737** | **-891** | **-4,606** | **-7,944** |
| **Disclosure of Information Relating to Tax-Exempt Organizations** | | | | | | | | | | | | | | |
| 1. Disclosure of written determinations | dia 12/31/02 | *Negligible Revenue Effect* | | | | | | | | | | | | |

| Provision | Effective | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2002-07 | 2002-12 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 2. Disclosure of name under which an organization does business and its Internet Web site | rfa 12/31/02 | | | | | | Negligible Revenue Effect | | | | | | | |
| 3. Modification to private foundation reporting of capital transactions | rfa 12/31/02 | | | | | | Negligible Revenue Effect | | | | | | | |
| 4. Disclosure that Form 990 is publicly available | pomiora DOE | | | | | | Negligible Revenue Effect | | | | | | | |
| 5. Disclosure to State officials of certain tax information related to certain section 501(c) organizations | DOE | | | | | | Negligible Revenue Effect | | | | | | | |
| **Total of Disclosure of Information Relating to Tax-Exempt Organizations** | | | | | | | **Negligible Revenue Effect** | | | | | | | |
| **Other Charitable and Exempt Organization Provisions** | | | | | | | | | | | | | | |
| 1. Modify tax on unrelated business taxable income of charitable remainder trusts | tyba 12/31/01 | [1] | -4 | -4 | -4 | -5 | -5 | -5 | -5 | -6 | -6 | -6 | -22 | -51 |
| 2. Modify tax treatment of certain payments to controlling exempt organizations | proaa 12/31/00 | -4 | -25 | -11 | -11 | -11 | -12 | -12 | -13 | -13 | -13 | -14 | -74 | -139 |
| 3. Simplification of lobbying expenditure limitation | tyba 12/31/01 | [2] | -1 | -1 | -1 | -1 | -1 | -1 | -2 | -2 | -2 | -2 | -5 | -15 |
| 4. Expedited review process for certain tax-exemption applications | afa 12/31/02 | | | | | | Negligible Revenue Effect | | | | | | | |
| 5. Clarification of definition of church tax inquiry | DOE | | | | | | No Revenue Effect | | | | | | | |
| 6. Extension of declaratory judgment procedures to non-501(c)(3) tax-exempt organizations | dma 12/31/01 | | | | | | Negligible Revenue Effect | | | | | | | |
| 7. Definition of convention or association of churches | DOE | | | | | | Negligible Revenue Effect | | | | | | | |
| 8. Provide a charitable deduction for certain expenses incurred in support of Native Alaskan subsistence whaling | epa 12/31/02 | --- | [2] | [2] | [2] | [2] | [2] | [2] | [2] | [2] | [2] | [2] | -1 | -3 |
| 9. Provide that certain payments by charitable organizations made by reason of the death, injury, wounding, or illness of military personnel incurred as a result of the war on terrorism are consistent with exempt purposes | pma DOE & pmb 9/11/03 | | | | | | Negligible Revenue Effect | | | | | | | |
| 10. Modify rules governing tax-exempt bonds for section 501(c)(3) organizations as applied to organizations engaged in timber conservation activities (cap at $2.0 billion) | bia 9/30/02 & bib 1/1/06 | --- | -7 | -20 | -30 | -32 | -31 | -29 | -27 | -27 | -27 | -27 | -120 | -255 |
| 11. Provide tax exemption for organizations created by a State to provide property and casualty insurance coverage for property for which such coverage is otherwise unavailable | tyba 12/31/02 | --- | -2 | -4 | -5 | -6 | -6 | -7 | -8 | -8 | -9 | -9 | -23 | -64 |
| 12. Conform provisions relating to arbitrage treatment of permanent university fund to State constitutional amendments | DOE | --- | -1 | [2] | [3] | [2] | -1 | [2] | [2] | [2] | [2] | [2] | -3 | -4 |
| 13. Matching grants to low-income taxpayer clinics for return preparation [4] | DOE | | | | | | No Revenue Effect | | | | | | | |
| 14. Increase percentage limits for certain employer-related scholarship programs under Revenue Procedure 76-47 to 35% of applicants or 20% of eligible students | gma 12/31/02 | --- | --- | -6 | -9 | -11 | -12 | -14 | -15 | -17 | -19 | -22 | -38 | -125 |
| **Total of Other Charitable and Exempt Organization Provisions** | | **-4** | **-40** | **-46** | **-60** | **-66** | **-68** | **-68** | **-70** | **-73** | **-76** | **-80** | **-286** | **-656** |

| Provision | Effective | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2002-07 | 2002-12 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Restoration of Social Services Block Grant Funding (outlays) [4]** | [5] | --- | -345 | -908 | -323 | 52 | 49 | 59 | 41 | --- | --- | --- | -1,475 | -1,375 |
| **Individual Development Accounts - provide a tax credit to eligible entities with respect to the first 300,000 individual development accounts established for low-income workers** | **tyea 12/31/03 & tybb 1/1/11** | --- | --- | -23 | -43 | -37 | -57 | -72 | -85 | -98 | -45 | [2] | -159 | -457 |
| **Total of Charitable and Tax Exempt Organization Provisions, SSBG Funding, and IDAs** | | -190 | -1,814 | -2,496 | -882 | -553 | -593 | -621 | -681 | -776 | -858 | -971 | -6,526 | -10,432 |
| **Revenue Provisions** | | | | | | | | | | | | | | |
| 1. The "Tax Shelter Transparency Act": | | | | | | | | | | | | | | |
| a. Provisions relating to reportable transactions and tax shelters (sections 601, 602, 604, 611, 612, 613, and 625) [6] | various dates after DOE [7] | 16 | 55 | 98 | 121 | 124 | 124 | 127 | 132 | 139 | 148 | 160 | 540 | 1,247 |
| b. Modification to the substantial understatement penalty (section 603) [6] | tyba DOE | --- | --- | --- | 8 | 11 | 19 | 23 | 26 | 30 | 34 | 38 | 38 | 188 |
| c. Actions to enjoin conduct with respect to tax shelters (section 614) | DOE | *Negligible Revenue Effect* | | | | | | | | | | | | |
| d. Understatement of taxpayer's liability by income tax return preparer (section 621) | dpa DOE | *Negligible Revenue Effect* | | | | | | | | | | | | |
| e. Impose a civil penalty (of up to $5,000) on failure to report interest in foreign financial accounts (section 622) | DOE | [8] | [8] | [8] | [8] | [8] | [8] | [8] | [8] | [8] | [8] | [8] | 1 | 3 |
| f. Frivolous tax submissions (section 623) | [9] | --- | 3 | 3 | 3 | 3 | 3 | 3 | 3 | 3 | 3 | 3 | 15 | 30 |
| g. Regulation of individuals practicing before the Department of Treasury (section 624) | ata DOE | *No Revenue Effect* | | | | | | | | | | | | |
| h. Affirmation of consolidated return regulation authority (section 631) | [10] | *Negligible Revenue Effect* | | | | | | | | | | | | |
| Total of the "Tax Shelter Transparency Act" | --- | 16 | 58 | 101 | 132 | 138 | 146 | 153 | 161 | 172 | 185 | 201 | 594 | 1,468 |
| 2. Tax treatment of inversion transactions; reinsurance agreements; require inverting entities to provide information to shareholders/partners and the IRS with respect to the tax treatment of the inversion | [11] | 25 | 81 | 97 | 117 | 140 | 168 | 202 | 242 | 290 | 348 | 418 | 628 | 2,128 |
| 3. Extend IRS user fees through 6/30/08 [4] | DOE | --- | --- | 33 | 34 | 35 | 36 | 28 | --- | --- | --- | --- | 138 | 166 |
| 4. Extend customs user fees through 6/30/08: | | | | | | | | | | | | | | |
| a. Merchandise processing fee [4] | DOE | --- | --- | 1,026 | 1,078 | 1,132 | 1,188 | 936 | --- | --- | --- | --- | 4,424 | 5,360 |
| b. COBRA fee [4] | DOE | --- | --- | 248 | 347 | 365 | 383 | 302 | --- | --- | --- | --- | 1,343 | 1,645 |
| **Total of Revenue Provisions** | | 41 | 139 | 1,505 | 1,708 | 1,810 | 1,921 | 1,621 | 403 | 462 | 533 | 619 | 7,127 | 10,767 |
| **NET TOTAL** | | -149 | -1,675 | -991 | 826 | 1,257 | 1,328 | 1,000 | -278 | -314 | -325 | -352 | 601 | 335 |

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding.

*[Legend and Footnotes for the Table appear on the following page]*

**Legend and Footnotes for the Table:**

Legend for "Effective" column:

afa = applications filed after
ata = actions taken after
bia = bonds issued after
bib = bonds issued before
cmi = contributions made in
dia = determinations issued after
dma = determinations made after
DOE = date of enactment
dpa = documents prepared after
epa = expenses paid after
pomiora = publications or materials issued or revised after
gma = grants made after
pma = payments made after
pmb = payments made before
proaa = payments received or accrued after
rfa = returns filed after
sma = sales made after
tyba = taxable years beginning after
tybb = taxable years beginning before

[1] Loss of less than $1 million.
[2] Loss of less than $500,000.
[3] Gain of less than $500,000.
[4] Estimate provided by the Congressional Budget Office.
[5] Effective for amounts made available for fiscal year 2003 and for amounts made available each fiscal year thereafter. The proposal requiring annual reports would be with respect to fiscal year 2002 and each fiscal year thereafter.
[6] Failure or substantial delay of forthcoming regulations for section 6011 of the Internal Revenue Code and other administrative actions to be taken by the Treasury Department or the Internal Revenue Service would reduce the estimated revenue effects of these provisions.
[7] Effective dates for provisions relating to reportable transactions and tax shelters: section 601 is effective for returns and statements the due date of which is after the date of enactment; section 602 is effective for taxable years ending after the date of enactment; section 604 is effective for communications made on or after the date of enactment; section 611 is effective for transactions with respect to which material aid, assistance or advice is provided after the section 612 is effective for returns the due date for which is after the date of enactment; section 613 is effective for requests made after the date of enactment; and section 625 is effective for activities after the date of enactment.
[8] Gain of less than $1 million.
[9] Effective for submissions made and issues raised after the first list is prescribed under section 6702(c).
[10] Effective for all taxable years, whether beginning before, with, or after the date of enactment.
[11] Effective for certain transactions completed after March 20, 2002, and would also affect certain taxpayers who completed transactions before March 21, 2002, and certain insurance risks reinsured after April 11, 2002.

### B. Budget Authority and Tax Expenditures

*Budget authority*

In compliance with section 308(a)(1) of the Budget Act, the Committee states that the revenue provisions of the committee amendment to the bill as reported involve new or increased budget authority.

*Tax expenditures*

In compliance with section 308(a)(2) of the Budget Act, the Committee states that the revenue-reducing provisions of the committee amendment to the bill involve increased expenditures (see revenue table in Part III.A., above). The revenue increasing provisions of the Committee amendment to the bill involve reduced expenditures (see revenue table in Part III.A., above).

### C. Consultation with Congressional Budget Office

In accordance with section 403 of the Budget Act, the Committee advises that the Congressional Budget Office has not submitted a statement on the committee amendment to the bill. The letter from the Congressional Budget Office was not received in a timely manner, and therefore will be provided separately.

## IV. VOTES OF THE COMMITTEE

In compliance with paragraph 7(b) of rule XXVI of the Standing Rules of the Senate, the following statements are made concerning the votes taken on the Committee's consideration of the amendment to the bill.

*Motion to report the committee amendment*

The amendment to the bill was ordered favorably reported by a voice vote, a quorum being present, on June 18, 2002.

*Votes on other amendments*

An amendment by Senator Breaux to increase the percentage limitations on certain scholarship grant programs of private foundations was agreed to by a voice vote.

An amendment by Senator Grassley to provide a tax credit for qualified financial institutions that have an individual development account program was agreed to by a voice vote.

An amendment by Senator Gramm to strike the provision excluding 25 percent of the capital gain on sales of land or interests in land made for conservation purposes was not agreed to by a voice vote.

An amendment by Senator Baucus in a Chairman's modification to the bill adding the provision regarding the affirmation of the consolidated return regulation authority was agreed to by voice vote.

## V. REGULATORY IMPACT AND OTHER MATTERS

### A. Regulatory Impact

Pursuant to paragraph 11(b) of rule XXVI of the Standing Rules of the Senate, the Committee makes the following statement concerning the regulatory impact that might be incurred in carrying out the provisions of the bill as amended.

*Impact on individuals and businesses*

With respect to the provisions that do not increase revenue, the committee amendment to the bill modifies the rules relating to (1) certain charitable giving incentives; (2) disclosure of information relating to tax-exempt organizations; (3) tax treatment and procedures relating to exempt organizations; (4) restoration of funds for the Social Services Block Grant; and (5) individual development accounts. The Social Services Block Grant provisions provide increased funding to States to support a variety of social services. Under the other provisions listed above, taxpayers may elect whether to avail themselves of the provisions. Thus, the provisions do not impose increased regulatory burdens on individuals or businesses.

With respect to the revenue-increasing provisions, the committee amendment to the bill modifies the rules relating to (1) the disclosure of reportable transactions and tax shelters; (2) the substantial understatement penalty; (3) actions to enjoin conduct with respect to tax shelters; (4) an understatement of a taxpayer's liability by an income tax return preparer; (5) the imposition of a civil penalty (of up to $5,000) on a failure to report interest in foreign financial accounts; (6) frivolous tax submissions; and (7) inversion and certain partnership transactions. These provisions relate to taxpayers that engage in certain tax avoidance transactions; taxpayers that have not undertaken or planned to undertake such transactions generally are not affected by the provisions of the bill. Thus, the revenue provisions generally do not impose increased regulatory burdens on individuals or businesses.

*Impact on personal privacy and paperwork*

The provisions of the committee amendment to the bill do not impact personal privacy. Individuals either elect whether to avail themselves of the provisions of the committee amendment to the bill or are subject to the committee amendment to the bill for engaging in certain tax avoidance transactions. The bill does not impose increased paperwork burdens on individuals. Individuals who elect to take advantage of provisions in the committee amendment to the bill may in some cases need to keep records in order to demonstrate that they qualify for the treatment provided. Individuals who elect to engage in tax avoidance transactions, and certain advisors who provide material aid, assistance, or advice with respect to such transactions, may in some cases need to file certain disclosure statements with the IRS.

## B. Unfunded Mandates Statement

The information is provided in accordance with section 423 of the Unfunded Mandates Reform Act of 1995 (P.L. 104–4).

The Committee has determined that the following provisions of the bill contain Federal mandates on the private sector: (1) provisions relating to reportable transactions and tax shelters; (2) modifications to the substantial understatement penalty; (3) actions to enjoin conduct with respect to tax shelters; (4) understatement of taxpayer's liability by an income tax return preparer; (5) the imposition of a civil penalty (of up to $5,000) on a failure to report interest in foreign financial accounts; (6) frivolous tax submissions; and (7) provisions relating to the tax treatment of inversion transactions and reinsurance agreements.

The costs required to comply with each Federal private sector mandate generally are no greater than the estimated budget effect of the provision. Benefits from the provisions include improved administration of the Federal income tax laws and a more accurate measurement of income for Federal income tax purposes.

## C. Tax Complexity Analysis

Section 4022(b) of the Internal Revenue Service Reform and Restructuring Act of 1998 (the "IRS Reform Act") requires the Joint Committee on Taxation (in consultation with the Internal Revenue Service and the Department of the Treasury) to provide a tax complexity analysis. The complexity analysis is required for all legislation reported by the Senate Committee on Finance, the House Committee on Ways and Means, or any committee of conference if the legislation includes a provision that directly or indirectly amends the Internal Revenue Code (the "Code") and has widespread applicability to individuals or small businesses. For each such provision identified by the staff of the Joint Committee on Taxation, a summary description of the provision is provided, along with an estimate of the number and type of affected taxpayers, and a discussion regarding the relevant complexity and administrative issues. Following the analysis of the staff of the Joint Committee on Taxation are the comments of the IRS regarding each provision included in the complexity analysis, including a discussion of the likely effect on IRS forms and any expected impact on the IRS.

*Direct charitable deduction for nonitemizers (sec. 101 of the bill)*

*Summary description of provision*

In the case of an individual taxpayer who does not itemize deductions, the bill would allow a direct charitable deduction from adjusted gross income for charitable contributions paid in cash. This deduction would be allowed in addition to the standard deduction. The deduction would be available only for that portion of contributions that in the aggregate exceed $250 ($500 in the case of a joint return). The maximum deduction would be $250 ($500 in the case of a joint return). The direct charitable deduction generally would be subject to the tax rules normally governing charitable contribution deductions, such as the substantiation requirements. The deduction would be allowed in computing alternative minimum taxable income. The direct charitable deduction would be effective for taxable years beginning after December 31, 2001, and before January 1, 2004.

*Number of affected taxpayers*

It is estimated that the provision could affect up to 85 million individual income tax returns each year the deduction is in effect.

*Discussion*

Individuals who do not itemize their deductions will need to keep additional records (e.g., canceled checks, a receipt from the donee organization, or other reliable written records) in order to substantiate that a contribution was made to a qualified charitable organization. The information necessary to implement the provision should be readily available to taxpayers (in the form of new tax return forms and instructions). The direct charitable deduction is expected to require an additional line on the individual income tax return forms. The provision might result in an increase in disputes with the IRS for taxpayers who are unable to substantiate a claimed deduction. Additional regulatory guidance will not be necessary to implement this provision. Any increase in tax preparation costs is expected be negligible.

DEPARTMENT OF THE TREASURY,
INTERNAL REVENUE SERVICE,
*Washington, DC, June 24, 2002.*

MS. LINDY L. PAULL,
*Chief of Staff, Joint Committee on Taxation,*
*Washington, DC.*

DEAR MS. PAULL: Enclosed are the combined comments of the Internal Revenue Service and the Treasury Department on the provision for a charitable deduction for non-itemizers from the Senate Finance Committee's markup of H.R. 7 the "Care Act of 2002," that you identified for complexity analysis in your letter of June 19, 2002. Our comments are based on the description of that provision in your letter and in JCX–57–02, Joint Committee on Taxation, Description of the Care Act of 2002, June 11, 2002.

Due to the short turnaround time, our comments are provisional and subject to change upon a more complete and in-depth analysis of the provision.

Sincerely,

CHARLES O. ROSSOTTI,
*Commissioner.*

Enclosure.

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## COMPLEXITY ANALYSIS OF PROVISION FROM H.R. 7, THE CARE ACT OF 2002

### CHARITABLE DEDUCTION FOR NON-ITEMIZERS

Provision: Taxpayers who do not itemize would be allowed to deduct their cash contributions to qualified charitable organizations in addition to claiming the standard deduction. This deduction would be calculated as the lesser of (a) the excess, if any, of the charitable contributions over $250 ($500 in the case of a joint return) or (b) $250 ($500 in the case of a joint return). The tax rules that apply to the charitable contribution deduction allowed to itemizers would generally apply to this deduction. The non-itemizer deduction would not be a preference item for purposes of the alternative minimum tax and would not affect the calculation of adjusted gross income (AGI). The proposal would be effective for tax years beginning after December 31, 2001, and before January 1, 2004.

*IRS and Treasury comments*

Two lines would have to be added to Forms 1040, 1040A, 1040EZ, 1040NR, and 1040NR–EZ for 2002 and 2003; one for the allowable deduction and one to reflect the total of the standard deduction and the charitable contribution deduction. One line would be added to the TeleFile Tax Record for 2002 and 2003 (taxpayers would enter their total contributions on the new line and TeleFile would calculate the allowable deduction). No new forms would be required.

The new deduction would also have to be reflected on Form 1040–ES for 2003 and in the instructions for Forms 1040X and 1045 for 2002 and 2003. Subsequent to enactment, the IRS may have to advise taxpayers who make estimated tax payments for 2002 how they can adjust their estimated tax payments for 2002 to reflect the new deduction.

Information necessary for taxpayers to determine their eligibility for the deduction, including the AGI limitation applicable to cash contributions, and the substantiation requirements would have to be reflected in the 2002 and 2003 instructions for Forms 1040, 1040A, 1040EZ, 1040NR, and 1040NR–EZ and for TeleFile.

A worksheet (consisting of four lines) for taxpayers to calculate their allowable deduction would have to be reflected in the 2002 and 2003 instructions for Forms 1040, 1040A, 1040EZ, 1040NR, and 1040NR–EZ.

Changes to the Telefile script for 2002 and 2003 would be required to allow the deduction to taxpayers who use TeleFile.

All of the above changes would have to be reversed for tax years beginning after December 31, 2003, to reflect the termination of the charitable deduction for non-itemizers (e.g., the lines would be removed from the Form 1040 series of returns, the worksheet would be removed from the instructions for these returns, and programming and script changes would be necessary to eliminate the deduction).

Ensuring compliance with the new charitable deduction would be difficult. The only means of verifying amounts deducted would be through examination, which is not practical because of the relatively small amounts involved.

The direct charitable deduction line on the 2002 and 2003 Form 1040 series of returns would need to be transcribed and incorporated into our computation of taxable income. The programming changes needed to effectuate this for 2003 processing (of 2002 returns) will put a strain on IRS' ability to complete and test other programming needed for the 2003 filing season. Since IRS is well into its program development for January 2003, we recommend that the effective date be delayed so that the provision would be effective for tax years beginning in 2003 and 2004. A delayed effective date would be especially important if the provision were not enacted before September 2002.

## VI. CHANGES IN EXISTING LAW MADE BY THE BILL AS REPORTED

In the opinion of the Committee, it is necessary in order to expedite the business of the Senate, to dispense with the requirements of paragraph 12 of rule XXVI of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill as reported by the Committee).

○